

4th QUARTER OUTLOOK

October 2016



The Fixed Income Review

Market Outlook

In this edition of PGIM Fixed Income's Quarterly Outlook, Robert Tipp, Chief Investment Strategist, looks at how the positive returns in Q3 differ from those in the first half of the year amid the evolution in monetary policies (page 3, click here to read).

<u>Jürgen Odenius</u>, Chief Economist and Head of Global Macroeconomic Research, provides insight into the slowing economic growth in developed economies in contrast to the recent growth acceleration in the emerging markets (page 4).

Sector Views

Corporate Debt (page 7, click here to read): We hold an overweight view of U.S. over European corporates given the former's wider spread levels and steady U.S. economic growth. Quantitative easing remains a huge technical support. Still favor U.S. money center banks.

Global Leveraged Finance (page 8): We're maintaining a constructive view of high yield, and in the U.S., we prefer longer-duration, BB-rated, non-commodity credits as we expect ex-commodity defaults to remain low in the near-term. In Europe, we favor secular growth stories, as opposed to more cyclical issues.

Emerging Markets Debt (page 9): After a solid Q3, our positive view on EM is supported by fundamentals that appear to be improving, supporting hard currency spread compression and EMFX. In countries where economic conditions have stabilized, rate cuts are expected, supporting an attractive view on local bonds.

Municipal Bonds (page 11): While weak technicals could weigh on tax-exempt munis in early Q4, our modestly positive view is supported by attractive opportunities as technicals may turn supportive by the end of the year.

Global Rates (page 11): Our constructive view on global rates is based on specific market areas, such as the 20-year segment of the JGB curve, long duration and a swap spread widener in the U.S., and the 10- to 15-year portion of the Bund curve.

Mortgages (page 12): We hold an underweight view on mortgages versus other spread sectors.

Structured Product (page 12): We remain very positive on topof-the-capital structure bonds. Elsewhere, AAA CMBS and CLO spreads could tighten amid investors' demand for yield in high-quality bonds. We remain positive on GSE credit risk mezzanine cashflows, while we are negative on CMBS and CLO mezzanine tranches.

Spotlight: Political Risks

The Brexit vote and the lingering uncertainty regarding how the UK will depart from the EU signaled a stark increase in political risks. With the markets more attuned to political developments, we provide our views on some political hotspots in Q4 and beyond (page 6, click here to read).

On the Road

Following recent trips to Brazil, Argentina, Mexico, and Russia, we outline the differing political and macro challenges facing each country (page 10).

Recent White Papers and Videos

The following material is also available at *PGIMFixedIncome.com*.



In his white paper, <u>Key Fault Lines in the Global Earthquake Zone</u>, Arvind Rajan, PhD, Managing Director and Head of Global and Macro, explores how failures in two major areas of developed market economies—macroeconomic and policy—have created a third fault line—political risk. Each carries the potential to create financial volatility, but they tend to be far more potent when acting together.



While some may blame the past year's market volatility on China's economic slowdown, falling commodity prices, or more recently Brexit, a recent white paper by Robert Tipp, CFA, Managing Director and Chief Investment Strategist, Central Banks of the World: Yield to the Markets!, discusses the possible culpability of overzealous monetary policy.



Michael Collins, CFA, Managing
Director and Senior Investment
Officer, looks at how the current credit
cycle "rhymes" with those in the past,
while also presenting distinct nuances
in a white paper entitled, <u>The Global</u>
<u>Credit Cycle: What Inning Are We In</u>
(Or, What Game Are We Even
Playing)?

Bond Market Outlook

The Tortoise or the Bear?

Q3 was light on events, leaving central bank bond buying to work its magic on the world's bond markets. That might be a slight oversimplification, but not by much. The numbers speak for themselves: despite low starting yields, many sectors added to what was already a solid year in the bond market in terms of both absolute and excess returns (see the following table).

Performance by Sector

		Total Return (%)				
	Q3 2016	YTD 2016	2015	2014	2013	2012
U.S. High Yield Bonds	5.49	15.32	-4.6	2.5	7.4	15.6
European High Yield Bonds	4.21	8.38	1.3	5.1	9.1	24.8
EM Debt Hard Currency	4.04	14.77	1.2	7.4	-5.3	17.4
U.S. Leveraged Loans	3.07	7.43	-0.4	2.1	6.2	9.4
Long IG Corporates	2.56	16.84	-4.61	15.73	-5.68	12.41
European Leveraged Loans	2.50	4.55	3.6	2.1	9.0	10.8
European IG Corporate	1.84	6.00	-0.6	8.4	2.4	13.6
EM Currencies	1.50	7.40	-7.61	-7.03	-2.04	7.45
U.S. IG Corporate Bonds	1.41	9.20	-0.7	7.5	-1.5	9.8
EM Local (Hedged)	1.20	7.29	-2.2	3.2	-4.2	8.9
Global Aggregate	0.82	9.85	-3.15	0.59	-2.60	4.32
Mortgage-Backed (Agency)	0.60	3.72	1.5	6.2	-1.50	2.6
CMBS	0.59	6.55	1.0	3.9	0.2	9.7
U.S. Aggregate	0.46	5.80	0.6	6.0	-2.0	4.2
U.S. Treasuries	-0.28	5.07	8.0	5.1	-2.8	2.0
Municipal Bonds	-0.30	4.01	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 September 30, 2016. 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.

Solid Returns? How and Why?

While returns over the first half of the year were fueled largely by the decline in government bond yields, in Q3 excess spread and spread compression were the big drivers of returns. This "catch-up" trade for the spread sectors was aided by stability in energy prices as well as a general search for yield that naturally followed the profound drop in sovereign yields during the first half of the year. The European Central Bank's corporate bond purchase program was another powerful force contributing to the narrowing of spreads during the quarter (see Corporate section). In general, interest rates remained within narrow ranges in Q3 with U.S. and Japanese long-term rates ending the period slightly higher. In the currency markets, the Federal Reserve's continued ratcheting down of its expected rate hike path has been enough this year—and was enough this quarter—to allow currencies, on average, to rise modestly versus the dollar.

Backdrop: Fundamentals Little Changed, Policy Keeps Evolving

While the economic backdrop (sluggish and challenged, see Economics section) remained little changed in Q3, policy

makers kept working. The Fed spent the quarter setting up for a December hike, while continuing to moderate its path for future expected hikes. The ECB established a committee to decide how to extend its easing pattern if it decides to do so beyond the current expiration in March 2017.

In an effort to keep rates low and therefore accommodative while inflicting less damage on market participants that depend on buying assets with yield, the Bank of Japan revamped its modus operandi (see Economics section). So far, the JGB curve remains low, but is steeper than before. Although this is presumably more palatable for investors, the policy may prove counterproductive if the combination of a slower expansion of the monetary base and a steeper—and therefore more attractive—yield curve ends up pushing the yen higher, which could hurt growth and possibly push the economy back into deflation.

Fireworks Ongoing: Policy and Politics

Looking at Q4 and beyond, yields are lower, spreads are tighter, and event risk appears reasonably high. The Fed thinks it can raise rates without dimming growth prospects. The BoJ, a big provider of liquidity to the world markets, has started a new policy variation.

And similar to the BoJ, the ECB is evaluating how to adjust the parameters of its bond purchases and prepare for an extension should it decide to do so. Meanwhile, political uncertainty has risen in the U.S. (see the following section on Political Risks).

Can Bonds Win?

Overall, we remain positive on the bond market, especially the higher-yielding sectors. Although yields and spreads are a bit lower, the sluggish economic backdrop and hyperaccommodative central bank motifs continue to point towards "low and lower" as the operative theme for government bond yields and spreads on non-government securities. As we've seen over the past quarters, however, a world of slow growth and low inflation and interest rates—combined with high leverage—leads to intermittent market volatility. Whether it is caused by the U.S. election, the Fed, the new BoJ policy, the Italian referendum in December, a shift in the trajectory of energy prices, a deterioration in China's economy, or something still unforeseen, we can't be sure. But in the end, investors will resume their search for yield, generally allowing bonds, especially the higher-yielding sectors, to continue outperforming cash. Meanwhile, as Fed rate-hike expectations continue to moderate, the dollar appears likely to underperform.

The Bottom Line: While short-term risks remain, the intermediate- to long-term outlook for bonds, especially the higher-yielding sectors, remains positive. Furthermore, market volatility should provide above-average opportunities for active management.

Global Economic Outlook

Sluggish Growth Despite Extraordinary Policy Accommodation

Developments in Q3 encapsulated many of the overarching themes we've previously laid out. Much of the quarter seemed to have laid to rest heightened concerns from Brexit to China, only to wake up to more volatile markets in September and market concerns about monetary policy effectiveness. Similarly, our below-consensus outlook on global growth has proven resilient, though this resulted from weaker-than-expected DM and stronger EM performance, respectively. Going forward, we anticipate these trends to broadly continue, with the U.S. elections, however, introducing another unknown.

Monetary policy came to the rescue again in Q3, but rising unease about its effectiveness seems to foreshadow renewed financial market volatility. The expeditious policy response by the Bank of England to the Brexit referendum and other central banks' readiness to act quickly calmed investors' nerves and fueled further risk taking. However, a confluence of monetary policy makers' apparent unease about the very low levels of interest rates—as aired at Jackson Hole—as well as the re-emergence of concerns about apparent limitations to further monetary stimulus at the ECB and the BoJ, resulted in considerable bouts of volatility. We have been skeptical about the scope for effective monetary policy easing and together with rising imbalances—as reflected in the large share of negative yielding bonds—we expect further volatility ahead, especially if inflation were to finally rise decidedly, as unlikely as this may seem (for more on our views regarding the effectiveness of current policies, click here to read "Are Central Banks Losing Their Mojo?").

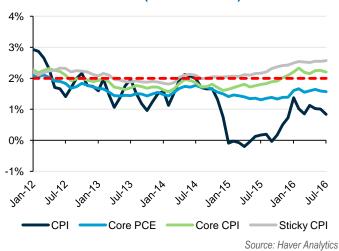
Government Bonds with Negative Yields



With respect to overall economic trends, our longstanding below-consensus global growth forecast remains intact, as greater-than-anticipated weakness in DM has been compensated by stronger EM growth. Downward DM growth revisions have been driven by the U.S. where the now familiar weak first quarter was followed by surprisingly poor growth in the second quarter. While the third quarter should record some rebound, underlying concerns about low productivity levels has led us to lower our growth forecast. In EM, we are not witnessing a return to the infamous decoupling discussion, but rather some gathering of an overall modest reform pace (e.g., Indonesia and India). Most importantly, and contrary to our expectations, China has adopted another round of large-scale stimulus that is boosting its growth outlook, albeit only temporarily and at the risk of macro stability.

In the U.S., there are increasing signs that the cycle is entering a more advanced stage. Notably, industrial activity has weakened and investment activity has remained subdued, although the adverse investment impact of lower oil prices and a stronger dollar appears to be waning. Employment growth has held up well, but the flip side has been falling productivity as evidenced by rising unit labor costs (for more on our views on long-term productivity developments, click here to read "Prospects for the U.S. Economy Over the Long Run"). As such, these developments are not necessarily consistent with an overly benign inflation view; indeed, inflation has been trending up and services inflation continues to hover around 3%, as shown in the following chart. That said, wage inflation has remained conspicuously absent, at least for this late part of the cycle. In this context, the Fed yet again refrained from tightening policy in September, but continues to signal its readiness to do so in the near future, provided the outlook remains favorable.

U.S. Inflation Measures (YoY in Percent)



In the euro area, the recovery, while continuing apace, appears to be losing momentum. The extraordinary stimulus that was imparted in 2014-15 by the depreciation of the euro, the collapse of oil prices, and the decline in yields to near record-low levels, now appears to be dissipating. This slowdown reflects, in part, a loss of momentum in consumption expenditures in response to waning stimulus from lower oil prices and easing wage gains. Meanwhile, headline inflation has been slow to rise, although we expect it to rise steadily towards core inflation of about 1%. A slowdown combined with further setbacks in lifting inflation towards the 2% target is likely

Global Economic Outlook

to facilitate downward revisions to the ECB's macro forecasts, especially its inflation forecasts, in December. At that point, we also expect the ECB to extend its asset purchase program by six to nine months beyond its current expiration date of March 2017. However, we expect the pace of asset purchases to remain unchanged (at €80 billion per month), although potential tapering cannot be ruled out.

Central Bank Inflation Measures



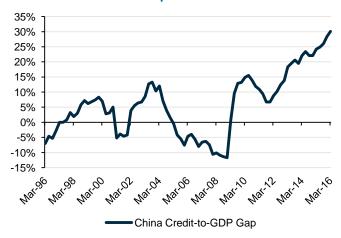
Source: Haver Analytics. T equates to the beginning of the respective QE programs.

Mindful of its continued difficulty in raising inflation, the BoJ revised its monetary policy framework. Underlying the persistent difficulty in raising inflation towards the 2% target is Japan's large international net wealth, which effectively limits the scope for the currency to spark an inflationary impulse. While the authorities have pushed for higher nominal wage increases, wage gains have thus far proved too timid to substantially boost demand and inflation. Calls for effecting minimum wage hikes (e.g., by the IMF) have not been heeded so far. We doubt that the BoJ's commitment to overshoot its inflation target is any more effective in raising inflation expectations than its current inflation target. More broadly, the BoJ's revised monetary policy framework—targeting long-dated yields while also aiming to maintain the pace of base money expansion at about ¥80 trillion per annum—is likely to be tested, especially should U.S. Treasury yields rise unexpectedly.

Despite the relative calm in Q3, concerns about China are likely to resurface. Efforts at deleveraging have been short lived, and China has returned to very high rates of debt growth, injecting credit at an annualized pace of about 30% of GDP. At this rate, the credit expansion in absolute terms exceeds the size of the Italian economy and, relative to its long-term trend, opens up whooping credit-to-GDP gap of some 30%. These developments place economy-wide leverage on a trajectory to surpass 300% of GDP by mid-2017. Moreover, while this credit impulse—which funds large fiscal and quasi-fiscal stimulus—has served to stabilize activity, in terms of growth, the incremental return from additional credit continues to decline, thus putting the limits of this policy into sharp focus. We therefore continue to expect renewed efforts to slow down debt

creation, although this would also lower measured GDP growth. In line with our past view, the yuan depreciation effected earlier this year has primarily served to boost exporters' profit margins rather than to undercut prices in the international market place. This allowed state-owned enterprises to curtail their loss and helped to avoid a renewed deflationary impulse in the global economy (for more on the yuan devaluation, click here to read "China's Constructive Devaluation Step").

China's Credit-to-GDP Gap



Source: Haver Analytics

Going forward, we expect a continuation of exceptionally loose monetary conditions in developed markets over the near and medium term. Global economic conditions are unlikely to be robust enough to give policy makers sufficient comfort to embark on a significant tightening cycle. However, it is unlikely that monetary policy will prove any more effective in boosting growth than it has been heretofore. The calls for additional fiscal stimulus are therefore likely to get louder. However, Abenomics as well as China's combined fiscalmonetary stimulus offer a cautionary tale about the effectiveness of stimulus. Moreover, with public debt sustainability already stretched in some countries, additional fiscal stimulus runs the risk of undermining investor confidence. To some extent, easy monetary conditions may have allowed policy makers to avoid tough structural measures—an issue consistently raised by the ECB. Be that as it may, the political environment for such reforms is unlikely to become easier and political risks, especially from upcoming elections, are considerable (see the following box on Political Risks). However, without reforms, low and further reductions in growth rates could be the result.

Global Economic Outlook

Perspectives on Political Risks

With the markets more attuned to political risks following the Brexit vote and its consequent uncertainty, the following represents our views on near-term political hotspots, which happen to occur in the U.S. and Europe in the coming months.

U.S.: The possibility of a Trump Presidency may be under-appreciated by the markets. In terms of changes to U.S. policy, we believe a Trump presidency could introduce uncertainty in trade (by potentially re-negotiating existing trade agreements, abandoning current trade negotiations—such as TPP or trade negotiations between the U.S. and Europe—or singling out China and Japan as currency manipulators) and in foreign policy (by questioning NATO's role, potentially re-aligning the U.S. with Russia, and/or supporting a more isolationist foreign policy in general). That said, should Trump become President, he may roll back or soften elements of his platform, and a Clinton presidency could also bring policy changes as she has also come out against the TPP. Fiscally, the policies Trump has proposed thus far—substantial tax cuts coupled with an increase in spending—could be fiscally expansionary, while Hillary Clinton's policies could be fiscally neutral to mildly expansionary. While the geopolitical impact of a Trump presidency remains unclear, his platform's emphasis on a more isolationist U.S. stance, if carried out, may bring significant new risks.

Europe: In the medium term, Europe may face multiple crises, both domestic and external. On the domestic front, the resurgence of the populist and anti-establishment parties—with their focus on globalization and the resulting rise in social inequality, job insecurity, and stagnant incomes—will continue to challenge the political center and will seek to influence and even dictate the economic and political agendas. As the political center cedes to the populist demands, the accompanying electoral shifts toward the extreme right or left will likely persist, further complicating policy making in the process. The stability once provided by centrist politics has now given way to more political competition. The splintering of the vote will make it more difficult to form coalitions and should make it more difficult to push through further reforms. It could also complicate the politics surrounding another bailout should it be needed in the case of Portugal, for example. However, looking ahead, with a new election cycle about to start in some major European countries, policy paralysis and/or ineffectiveness are likely to define the political scene.

The North-South divisions on economic policy and reforms and the East-West split on migration, national identity, and security and defense will likely persist in the months ahead. Meanwhile, upcoming elections in Netherlands, Germany, and France, as well as Italy's referendum on constitutional reform will likely pressure national governments into opposing new policy initiatives, and/or into pursuing more populist agendas (for more on political risks as well as other major uncertainties for investors, click here to read Key Fault Lines in the Global Earthquake Zone.) Angela Merkel's political future is another significant risk facing Europe in the months ahead. Should Merkel decide not to run in Germany's next general elections, Europe will be left rudderless in an increasingly challenging domestic and external environment. Finally, uncertainty in Europe will also stem from political noise in Spain, banking and fiscal concerns in Portugal, and yet another round of Greek negotiations related to the next review of the bailout program.

On the external front, Europe will continue to face challenges from Brexit and Russia. The UK's stated plan to invoke Article 50 by the end of March 2017 could lead to hardening attitudes of both national governments and European institutions, which could consequently increase the chances of a "hard" Brexit, with significant financial, economic, and trade implications for both the UK and Europe. Russia, on the other hand, will continue to test Europe by frustrating its efforts to address risks emanating from immigration, the turmoil in Syria/the Middle East, the political crisis in Turkey, and the long-standing conflict in the Ukraine.

Upcoming Political Events of Note					
Country	Vote	Date	Notes		
U.S.	Elections for President, House of Representatives, Senate	November 8, 2016	Republican nominee Donald Trump has positioned himself as an alternative to the Republican and Democratic political establishment.		
Italy	Economic Reform Referendum	December 4, 2016	A vote to reject PM Renzi's economic and constitutional reforms could force early elections and open a window for the anti-EU Five-Star Movement.		
Austria	Presidential Election	December 4, 2016	The Freedom Party, which is considered on the far-right of the political spectrum, has been polling well prior to the re-vote.		
Germany	Merkel's Campaign Decision	December 2016	After losing ground to the AfD in local elections, Chancellor Angela Merkel will decide whether to run for another term before federal elections in the fall of 2017.		
Netherlands	Second Chamber Elections	March 2017	The Party for Freedom (PVV) is considered far on the right of the political spectrum and has been polling well ahead of legislative elections.		
France	Presidential and National Assembly Elections	April and June of 2017	Marine Le Pen, member of what is considered to be the far-right National Front party, is in the running. The party will also be a factor in parliamentary elections.		

Source of voting dates: ElectionGuide.org

Q4 2016 Sector Outlook

U.S. and European Corporate Bonds

U.S. corporate bonds delivered a total return of 1.41% in Q3 with an excess return to U.S. Treasuries of 173 bps. U.S. corporate bonds rallied smartly during the quarter with spreads tightening 17 bps to 138 bps over similar-maturity U.S. Treasuries. U.S. corporates benefitted from positive, albeit modest, economic momentum and strong demand from global investors seeking yield against a backdrop of aggressive central bank policies that include negative interest rates in Europe and Japan and the ECB's corporate bond purchase program.

European corporate bonds also delivered positive returns as the market rallied following the Brexit vote selloff and the ECB's corporate purchases continued at a steady clip. Spreads tightened 22 bps during the quarter to close at 114 bps.

	Total Return		Spread	OAS	
	Q3	YTD	Q3	YTD	9/30/16
U.S. Corporate	1.41%	9.20%	-17 bps	-27 bps	138 bps
European Corporate	1.84%	6.00%	-22 bps	-19 bps	114 bps

Represents data for the Bloomberg Barclays U.S. Corporate Bond Index and the Bloomberg Barclays European Corporate Bond Index (unhedged). Sources: Bloomberg Barclays as of September 30, 2016. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

U.S. Corporate Bonds

Heavy new issuance dominated the quarter with new supply to date running on pace with last year's record level. In September alone, issuance topped \$125 billion with minimal to no concessions. While many issuers sought to lock in ultra-low rates, debt-financed mergers and acquisitions and share buybacks also contributed to supply, as did an increase in short-term financial issuance in response to impending money market reform and the resulting increase in LIBOR. On the demand side, both U.S. and non-U.S. investors turned to the more attractive-yielding U.S. corporate market with most deals three times oversubscribed. Demand was especially strong from European and Japanese investors given their negative-rate backdrop. Many non-U.S. investors are now shifting out on the corporate yield curve for an additional yield pickup.

The industrial and utility sectors outpaced financials during the period as concerns over ultra-low interest rates and the Fed's reluctance to raise rates weighed on the financial sector. Fundamentals for most consumer industries generally remained healthy with almost all industries generating positive cash flow before dividends and share buybacks. Revenue and earnings growth remains challenged, however, and fundamentals for high-quality (A to AAA rated) industrials are weakening due to increased leverage to finance M&A and share buyback activities. Commodity and energy credit metrics

are stabilizing as companies take steps to shore up their balance sheets.

During the period we continued to favor U.S. centric, consumer-related sectors including autos, chemicals, health insurers, paper, and select pharmaceuticals. We are overweight BBB-rated long-maturity corporates due to the steep spread curve and issuers' efforts to maintain their investment-grade status. Likewise, we are underweight A and higher-rated industrials in light of increased event risk and tight spread levels. We still favor U.S. money center preferred debt given their attractive yields, higher capital ratio requirements, and relative immunity to event risk. We are less favorable on life insurers as low rates continue to stress their income statements. We continue to look for opportunities in the energy and metals/mining sectors and favor taxable revenue municipal bonds given their low propensity for event-driven risks.

European Corporate Bonds

European corporate bonds enjoyed a strong summer rally with UK issuers rebounding following the Brexit vote and the market largely being driven by the supportive policies of the ECB and BoE. The ECB's corporate bond purchase program continued on trend while the BoE entered the sterling corporate bond market in late September.

In addition to the technical tailwind from central bank corporate purchases, other positives include robust credit fundamentals, generally cautious management focused on balance sheet strength, and a bottoming out of European economies. Growth is projected to be a positive 1+% in 2016, a notable improvement over prior years. Lower energy prices and a weaker FX are supportive, as are the ECB's and BoE's plans to remain accommodative to keep economic growth on track.

During the period, new issuance hit record levels with significant reverse yankee issuance from U.S. companies looking to capture rock bottom yields. Demand was equally strong, with the ECB providing a technical lift. As the quarter ended, however, the market appeared to have found a range with most new issues having little concessions, book orders declining, and very little follow-up buying. Secondary market activity also turned sluggish with less liquidity.

Given the sharp compression in euro spreads this year, we believe euro industrials are fairly priced and are likely to remain near current levels given central bank buying. M&A activity has been slowly increasing, but remains well below U.S. levels. We are also keeping a close eye on front-end spreads, which may come under pressure as negative rates push spreads wider and credit curves flatter.

In this environment, we have reduced our overweight in euro spread risk and hold a more constructive view on non-euro issuers. We remain focused on reverse yankee issues that are priced at discounts to where they trade in U.S. dollars and have spread levels that compensate for the lack of name recognition.

Q4 2016 Sector Outlook

We remain underweight European financials and prefer Northern European issues over peripheral country debt. Within euro-area industrials, we are focusing on 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 reduced our overweight in euro spread risk in favor of other opportunities, including U.S. spread product and reverse yankee issuers. Within the financial sector we continue to hold an overweight to U.S. money center banks and an underweight in euro zone banks. As in U.S. portfolios, 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.

Overall, we believe U.S. and non-euro zone spreads remain attractive and have room to tighten, while euro spreads appear fairly priced. Key risks in the short term include uncertainty over the U.S. election and Fed policy. Longer term, risks include increased leverage in China and uncertainty surrounding the long-term effects of Brexit across the UK and Europe.

OUTLOOK: Overweight U.S. vs. euro corporates given wider spread levels and steady U.S. economic growth. Quantitative easing remains a huge technical support. Still favor U.S. money center banks.

Global Leveraged Finance

The global reach for yield continued in Q3 as the leveraged finance markets stabilized in the aftermath of the Brexit vote and the highly-anticipated BoJ and Fed meetings. In the U.S., the market enjoyed another quarter of strong performance, led by the continued resurgence of the commodity sectors and outperformance from lower-rated credits. The European high yield market continued to benefit from the trickle-down effect of the ECB's purchases of investment-grade corporates, many of which traded with negative yields as Q3 concluded.

	Total F	Return	Spread	OAS	
	Q3	YTD	Q3	YTD	9/30/2016
U.S. High Yield	5.49%	15.32%	-124 bps	-198 bps	497 bps
Euro High Yield	4.21%	8.38%	-72 bps	-92 bps	428 bps
U.S. Leveraged Loans	3.07%	7.43%	-57 bps	-103 bps	486 bps
Euro Leveraged Loans	2.50%	4.55%	-35 bps	-17 bps	480 bps

Sources: BofA Merrill Lynch and Credit Suisse as of September 30, 2016. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index. European returns euro hedged.

U.S. High Yield and Leveraged Loans

With the risk-on trade in full swing following the Brexit vote, the CCC portion of the market once again outperformed, outpacing BBs and Bs by 440 bps and 256 bps. Year-to-date, the CCC and below portion of the market is up 28.81%—more than double the returns of the higher-rated portions of the high yield market.

Echoing the tone from Q2, commodities, particularly the metals & mining, chemicals, and energy sectors, outperformed the broad market for the quarter, and remained the top three performing sectors so far this year. While the performance of these sectors has been notable, more than two-thirds of all default activity recorded during the year emerged from the energy and metals & mining sectors. Although default rates are expected to end the year in-line with long-term averages (3.5%-4.0%), the rate decreases significantly when commodity issues are excluded, as noted by J.P. Morgan. Additionally, the default rates implied by high yield energy spreads indicate that the market is not appropriately pricing in the downside risks to high yield energy credits (click here for more on the rationale for underweighting high yield energy).

High-yield fund flows were positive in Q3, despite significant outflows late in the quarter in advance of the BoJ and Fed meetings. The BoJ did make some policy tweaks following its reassessment, and the Fed appears set to hike rates in December (albeit on a very gradual trajectory), but the general policy accommodation combined with investors' appetite for risk should keep demand for the asset class high and flow activity positive. Meanwhile, new net issue supply slowed somewhat on the back of a reduction in M&A related activity and an increase in refinancing issuance given the low-rate environment.

With strong demand for U.S. high yield being met with limited supply, the potential exists for further spread tightening. However, given current spread levels which are in line with their 20 year averages, the environment could be one where coupon income could be a larger component of returns.

While U.S. high yield appears to be fairly valued to slightly cheap, and the ex-commodity default rate should remain manageable, our outlook for spreads is muted with the expectation that they end Q4 similar to current levels. We believe the longer-duration, higher-quality portion of the market has more upside given the attractive spread and price levels, which in turn offers the most attractive credit risk vs. spread trade-off. Not only does this segment of the market benefit from dovish central bank policies, but it is also less negatively impacted by weak global growth or the uncertain political developments from the upcoming U.S. presidential election. We also believe that the market is undervaluing the downside risks associated with high yield commodity credits.

U.S. leveraged loans posted solid returns for the quarter, up 3.3%, driven by manageable net new issuance, consistent inflows, and an increase in CLO pricings. As was the case with

Q4 2016 Sector Outlook

high yield bonds, CCC-rated loans finished ahead of both Brated and BB-rated loans. Given the recent rally, more than 50% of loans are currently trading above par, according to J.P. Morgan. While this may raise concerns about loan repricings, the newly allocated bonds also tend to trade higher.

European High Yield and Leveraged Loans

Underpinned by strong demand for risk assets primarily due to the swift stabilization of the UK political landscape along with the BoE releasing details of its bond purchase program, the broad European high yield index slightly trailed the U.S. market in Q3 as B-rated credits outperformed both the BB-rated and CCC-rated portions of the market during the guarter.

Flow activity turned positive for the year in Q3 after a stretch of steady outflows ahead of the central bank policy decisions. We expect inflows to continue, given the influence that the QE programs of both the ECB and BoE have on high-yield demand.

Primary issuance was light for the quarter and while typical for this time of the year, issuers' reluctance to bring deals to market was further compounded by the volatility surrounding Brexit. Despite issuance increasing late in Q3, new issue volume has trended below last year's total, which should provide a supportive technical backdrop for the market going forward.

Moody's default rate held steady at 2.4%, and is expected to decline to 1.7% by year-end. Defaults in general should 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 upcoming maturities should be easily absorbed.

The direction of the European high yield market in Q4 is highly dependent on what occurs in the government bond markets given the interest-rate sensitivity of the recent BB issuance and lack of duration hedging by high yield managers. The abundance of crossover buyers in the European high yield market could lead to a significant repricing of risk assets if there is any change in investor sentiment regarding the continuity of global monetary policy. Nevertheless, the European high yield market remains attractive, supported by reasonable spread levels and the limited exposure to the commodity and energy space. We will continue to maintain our overweight to B-rated credits and will seek to increase our allocation to BBs as well. While sterling-denominated credits continue to trade wider than euro-denominated names, we will seek out relative value opportunities between sterling- and euro-denominated bonds.

Despite posting positive total returns in Q3, European leveraged loans lagged high yield bonds for the quarter. We don't expect this underperformance to continue, as loans

should outperform bonds in the near term given the strong technicals in the loan market compared to the bond market.

OUTLOOK: Constructive. In U.S. high yield, we prefer longer duration, BB-rated, non-commodity credits. We expect ex-commodity defaults to remain low in the near term. In U.S. leveraged loans, renewed demand from retail investors should keep spreads tight. We continue to favor the single-B rated portion of the European high yield market, and European loans remain attractive vs. bonds given the strong demand.

Emerging Markets Debt

EM hard currency spreads tightened solidly in Q3 with all regions experiencing tighter spreads. EM local yield and currencies had marginal positive returns as the market shook off the initial negative impact of the Brexit vote.

	Total Return		Yield/Spread Change		OAS/Yield
	Q3	YTD	Q3	YTD	9/30/2016
EM Hard Currency	4.04	14.77	-52	-79	336
EM Local (hedged)	1.20	7.29	-14	-95	6.183%
EMFX	1.50	7.40	-39	-152	3.48%
EM Corporates	3.07	11.11	-49	-82	346

Source: J.P. Morgan as of September 30, 2016. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

In hard currency bonds, Africa was the best performing region with a spread tightening of 92 bps, while Asia tightened the least at 38 bps. In a continuation of last quarter's theme, commodity producing countries continued to outperform even as oil prices wavered during the quarter. Zambia (+14.18%), Ivory Coast (+7.65%), Ghana (+8.48%), Iraq (+8.30%), and Tunisia (+9.15%) were some of the top performing countries, while defensive oil importers, such as Latvia (+2.11%) and Philippines (+0.86%) underperformed. Venezuela (+28.36%) was the standout performer as investors priced in optimism regarding an upcoming liability management swap. The primary market was active during the quarter, with over \$132 billion of new sovereign and EM corporate bond issues.

In local bonds, Indonesia (+3.33%), Colombia (+2.48%), and Romania (+2.48%) were the top performers. With a few exceptions, inflation is well contained across the universe, with many countries in Asia and Eastern Europe experiencing inflation substantially below the central bank target band. Latin America was more mixed with inflation in Brazil and Colombia declining, but still higher than central bank targets. Next year, we are expecting central bank easing in Russia, Brazil, Indonesia, and India, and we're anticipating rate hikes in Mexico, Korea, and Romania.

Q4 2016 Sector Outlook

In EM currencies, South Africa (+8.65%), Hungary (+3.46%), and Argentina (+3.35%) posted the strongest total returns. South Africa benefitted from a positive terms of trade shock and a material improvement in its current account in Q2. Hungary gained on the back of a widening current account surplus, which printed at +6.4% in Q2 and a central bank that likely ended its easing cycle in late May. Argentina's currency was stable, and the high yield of 25% produced strong total returns. Mexico (-3.71%) was the outsized underperformer driven by Donald Trump's ascent in U.S. election polls as his policies are regarded as being detrimental to Mexico's economy given his stated intent to restructure the NAFTA. Despite the YTD appreciation in most EM currencies, real effective exchange rates remain cheap, particularly in LatAm, EMEA, and parts of Asia. Improving EM growth, significant adjustment observed in many countries' external balances, attractive nominal and real yields, and status quo in developed markets with accommodative monetary policies and low yields could drive further positive performance in EM currencies over the medium term.

On the Road

Recent trips to Brazil, Argentina, Mexico, and Russia highlight the differing political and macro challenges facing each country. Both Brazil (+25.94%) and Argentina (+21.84%) have significantly outperformed the overall market in hard currency bonds through Q3, compared with an index return of 14.77%. In both cases, positive political dynamics contributed to the strong returns.

In Brazil, the transition to the Temer-led government following the impeachment of former President Dilma has improved sentiment. We came away comfortable that the highly regarded economic team will be successful in passing spending caps and that the disinflationary trends will allow the central bank to begin a rate cutting cycle this year. While a necessary condition, these measures are not sufficient to stabilize the debt dynamics. Temer and team will have to exhibit strong political will to pass and implement social security and other structural and micro reform initiatives to improve the investment climate. Additionally, there is a marked attempt to attract investment in much needed infrastructure projects with improved terms for private investors. The dramatic improvement in the financial outlook for Petrobras is an example of how market-friendly and transparent policies can reprice assets. It is key that Temer and team set the stage for a meaningful recovery, which will help ensure that a more orthodox agenda continues after the 2018 Presidential elections and will be central in stabilizing Brazil's domestic debt dynamics. Challenges to this scenario include the risk of additional corruption probes, a very high unemployment rate, and rising public frustration if growth does not recover. Our investment conclusion is that quasi-sovereign bonds that still trade very wide to the sovereign and select external sovereign bonds still offer upside. Brazil's external liquidity and solvency strength will help limit the downside if the risk environment deteriorates. The possibility of a significant rate cutting cycle,

potentially approaching close to 400 bps, makes nominal local bonds attractive

In Argentina, we were impressed with the potential for a significant rebound in growth next year on the back of an increase in investment and in consumption. On this front, we are encouraged with how President Macri and team continue to court the global investment community for foreign direct investment and portfolio flows with a broad scheme to open up and normalize sectors that suffered from underinvestment during the previous administration. Tax-amnesty inflows could be significant and will help with the financing needs of the government. The government has opted to implement a gradual fiscal adjustment to ensure governability and enhance its standing ahead of the mid-term elections in a year. We think this makes sense politically. The recovery in growth—base case of 3.5%—will provide the administration time to stabilize debt dynamics. It will be important for the central bank to bring the very high inflation rate closer to the target of 17%. Challenges will likely emerge in managing wage negotiations next year and in continuing to correct tariffs and subsidies in order to eliminate distortions. Politically, the more marketfriendly factions of the opposition appear ready to support Macri's agenda. The \$20 billion in external debt supply has been well received, and its sovereign global bonds are fair at current levels. Provincial and local bonds are attractive, along with select euro-denominated issues. Given the expectation for continued rate cuts and for a strong FX, exposure to the highyielding currency is also attractive.

In contrast to Brazil and Argentina, in Mexico, while the macroeconomic backdrop is more solid, the political dynamics seem to be headwinds for the country. The President is not popular, and the Pena-Nieto administration is seen as a lame duck government. Corruption and security will become the main themes in the 2018 elections. In the more immediate timeframe, challenges include weak fundamentals at Pemex, an uncertain outlook for oil, the upcoming U.S. elections, and potential jitters from Fed policy. This backdrop helps explain the underperformance of Mexican fixed income assets this year. A very solid and well articulated policy framework mitigates these risks. Going into next year, macroeconomic fundamentals will likely improve at the margin amid a moderate strengthening of economic activity. Fiscal consolidation will be a priority, but could be compromised given some of the risks. Mexico has the benefit of a solid investment grade "balance sheet," giving policy makers some flexibility. Pemex will challenge the outlook, but it is implementing necessary changes, and we believe the government will support Pemex more explicitly if needed. Spreads in Pemex, the Mexican peso, and local bonds reflect a good amount of downside risk already. There is potential for a recovery following the U.S. elections.

The key takeaway **from Russia** is that the macro adjustment continues in the face of the current oil price environment, supported by solid fiscal and monetary policy. What lacks is a strong commitment to set the conditions for a competitive

Q4 2016 Sector Outlook

economy and stimulate growth more meaningfully, particularly over the medium term. President Putin remains well entrenched, and it's unlikely any challenges to his authority will emerge through the Presidential elections in the spring of 2018. Value remains in sovereign and quasi-sovereign bonds as the credit continues to reprice, and we expect Russia to issue opportunistically. Recent rating agency improvements in the outlook on the BB+ ratings confirm our long-held view that Russia is an investment-grade country.

OUTLOOK: Positive. EM fundamentals appear to be improving, supporting hard currency spread compression and EMFX. In countries where economic conditions have stabilized, rate cuts are expected, supporting an attractive view on local bonds.

Municipal Bonds

AAA-rated municipal bonds underperformed U.S. Treasuries—10 years and longer—with the 30-year Municipal/Treasury yield ratio rising to 99.1% from 87.4% (at the start of Q3). Despite continued strong mutual fund inflows (approximately +\$17 billion in Q3 and \$50 billion YTD) and manageable supply (\$110 billion in Q3 and \$334 billion YTD), rising interest rates contributed to negative total returns for Q3 for high grade municipals (-0.30%). High yield municipals turned in stronger performance (+1.29%) due to the continued rally of various Puerto Rico credits (+6.75% in Q3). Year-to-date returns are positive for high grade, high yield, and Puerto Rico, which returned +4.01%, +9.37%, +15.68% respectively. Long taxable municipals returned +0.66% in Q3 and +13.09% year-to-date, underperforming the long corporate index over both time periods.

While the Commonwealth of Puerto Rico defaulted on nearly \$807 million in GO and GO-guaranteed debt since July 1st, various Puerto Rico credits rallied in Q3 as the President announced the appointment of the seven member bi-partisan federal oversight board, which will have broad fiscal oversight regarding the Commonwealth.

Chicago's city council approved a water and sewer usage tax to raise revenues to fund contributions to the city's largest pension plan, which will be phased in over five years. Subsequently, Chicago GO bonds rallied in Q3 as the city demonstrated a willingness to act. The gridlock continues in Illinois as the lack of a full budget continues to pressure the state's financial position. Moody's estimates that the backlog of bills will grow from \$8 billion at the end of fiscal year 2016 to \$14 billion or more by fiscal year-end 2017.

Increased volatility is expected as technicals weaken early in Q4 before turning positive towards year end. While positive fund flows into the asset class have created a supportive environment over the past year, the back-up in rates in Q4 could negatively impact this trend. Given the attractive taxable-

equivalent yields, any weakness in tax-exempts should provide attractive buying opportunities.

Investors will focus on statements and developments from the fiscal control board in Puerto Rico regarding an agenda and timeline moving forward. In addition, the Congressional Task Force on Economic Growth in Puerto Rico (also established under PROMESA), is required to submit a report to Congress by year end on identifying ways to spur economic growth on the island.

We anticipate an increased focus on unfunded pension obligations as investment returns fall well below expected returns. The outcome of the U.S. Presidential election could heighten the risk of tax reform. We expect taxable municipals to perform in line with corporate bonds, with the potential to outperform if corporate M&A activity persists.

OUTLOOK: Modestly positive. While weak technicals could weigh on tax-exempts early in Q4, any selling pressure could present attractive opportunities as technicals should turn supportive by year end.

Global Rates

Global rates investors anxiously awaited central bank guidance through much of Q3 as developed market rates remained relatively range-bound. Concurrent BoJ and FOMC meetings induced much awaited volatility as the BoJ's shift in focus led the JGB curve to bear steepen while the Fed's lowered "dot plot" trajectory provoked flattening along the Treasury curve.

The BoJ's policy reassessment and shift in emphasis toward the slope of the yield curve provided a catalyst for a 20 bps bear steepening move in the JGB curve in the first two weeks of September. That steepening faded later in the month and implied volatility along the curve was aggressively sold. The market believes that the BoJ will attempt to control the front end to the 10-year segment of the curve and allow the market to develop the neutral level for long-term bonds. This is the BoJ's most aggressive attempt yet to steepen the yield curve while inducing inflation.

Once the JGB yields stabilize, we believe exposure to the 20year sector offers the best carry and roll down opportunities. Presumably, the fund-supplying operation, which was extended to 10 years, may encourage banks to increase their purchases at the 20-year segment of the curve as well.

The U.S. Treasury and German Bund curves also steepened in the first two weeks of September by nearly 30 bps and 23 bps, respectively. Following the flattening moves after the BoJ and the Fed meetings, the U.S. curve was the only developed market curve to close the quarter flatter.

Looking ahead, we expect the Fed to hike the fed funds target rate in December, all else being equal, and remain constructive

Q4 2016 Sector Outlook

on extending duration in the U.S. given the curve's elevated risk premium. We expect Treasuries to post positive returns in $\Omega 4$

While intermediate swap spreads closed Q3 unchanged, swap spread wideners (versus OIS rather than LIBOR) remains one of our favorite positions given its attractive carry opportunities.

We maintain a neutral view on TIPS as the general inflation picture continues to appear benign even as breakeven rates ticked higher at the end of the quarter. The five-year breakeven rate was 1.49% at the end of the quarter, up slightly from 1.45% as of July 1, 2016. The 10-year breakeven rate ended Q3 14 bps higher at 1.61%.

Although the ECB refrained from any meaningful policy changes in Q3, we believe it will likely extend its Public Sector Purchase Programme beyond March 2017 during its December meeting. While Bunds remain range bound in the current quarter, the extension will likely keep downward pressure on yields given the general lack of supply and the relative steepness of the curve. We believe investors' reach for yield will continue to exert downward pressure on yields in the 10- to 15-year segment of the Bund curve.

Yields on UK Gilts appear rich at this point, and we believe Gilts will generally underperform the other G4 rate markets.

OUTLOOK: Constructive. With the policy uncertainty that clouded much of Q3 somewhat resolved, specific areas of the developed rate markets, such as the 20-year segment of the JGB curve, long duration and a swap spread widener in the U.S., and the 10- to 15-year portion of the Bund curve, appear attractive.

Mortgages

Agency mortgage-backed securities outperformed U.S. Treasuries in Q3 with spreads tightening solidly versus swaps. Mortgages delivered 0.60% in total return during the period with an excess return of +64 bps to similar-maturity U.S. Treasuries. Year-to-date, mortgages have posted a 3.72% total return.

MBS performance was driven primarily by strong demand, including outsized buying by banks and non-U.S. investors, which helped tighten spreads back to 2015 year-end levels. As expected, MBS prepayments rose during the period in response to low mortgage rates in late Q2. In turn, the Federal Reserve increased its mortgage reinvestments given higher prepayments on its holdings. As the quarter ended, we believe peak prepayment speeds are behind us unless primary rates decline materially below recent levels. The extension of the Home Affordable Refinance Program to October 2017, to bridge the new high loan-to-value refinance program rollout, should not materially impact prepayment activity.

While mortgages may continue to benefit from the current low-volatility environment, volatility could actually increase in Q4 given the potential for a Fed rate hike and higher net supply despite elevated mortgage rates and the fall/winter seasonal effect. However, we may see additional purchases by yield-based accounts should interest rates rise.

Across portfolios we are tactically rotating Freddie Mac and GNMA2 positions versus Fannie Maes. We prefer 30-year coupon exposure versus intermediate maturities and have reduced TBAs versus specified pools.

OUTLOOK: Underweight in favor of other spread sectors.

Structured Product

Structured products had a Q3, continuing the trend that began in the prior quarter. We expect spreads to be range bound to tighter for the remainder of the year as low and even negative yields across developed markets continue to make U.S. spread product attractive.

We expect this technical to bode well for spread stability and possibly auger tightening for high-quality structured product bonds in the intermediate term, especially AAA CMBS and CLO bonds. Low supply across structured product sectors has also supported spreads.

Non-Agency RMBS: The housing market remains very strong, with existing home sales at post-crisis highs. Inventory is incredibly tight, and affordability is still high compared to historical standards. While mortgage credit availability is still restrictive in comparison to pre-crisis standards, room exists for responsible loosening of origination standards. Mortgages originated post-crisis have been to high-quality borrowers, which lessens the likelihood of a housing selloff.

Spreads moved tighter in Q3, and are now at post financial crisis tights (LIBOR +200–275 bps for senior '06/'07 legacy bonds). The dominant technical remains the 10-15% contraction in the asset class on an annual basis. Additionally, with the asset class in strong demand by long-only asset managers, it is less vulnerable to the pressures of the hedge fund industry, which we see as a risk to other parts of the structured product market.

Furthermore, representations and warranties (R&W) settlements, which are a source of valuation uncertainty, are poised to pay out or at least be definitively resolved. This should be supportive of spreads. For example, Countrywide's spreads rallied sharply after its Q2 settlement distribution.

We think that current spread levels can persist, driven by strong technicals and still-improving fundamentals. However, from a relative value perspective, non-agency RMBS looks increasingly less attractive compared to other structured product assets, such as CLOs and esoteric ABS. Away from

Q4 2016 Sector Outlook

the U.S., UK RMBS rallied significantly in Q3 due to limited supply, Bank of England QE, and the recent full redemption of the £3bn Aire Valley UK RMBS trust (Bradford and Bingley). While the fallout from Brexit and the pullback in UK housing appears to be contained for the time being, we've only seen the opening act of what is likely to be a protracted negotiation. Regardless, we think UK RMBS represents decent relative value, although liquidity and sourceablity is scant.

ABS: We remain bullish on the credit fundamentals of the U.S. consumer and related assets. For example, credit card default rates are the lowest in decades. Our favorite positions in this sector are from established lenders that focus on cashflow underwriting, such as One Main.

We also find value in AAA rental car ABS at swaps +135 bps, which has significant structural protections to insulate the ABS bonds from a rental car company bankruptcy. Marketplace lending or Fintech, which has been the subject many media stories, continues to be an area of analysis; however, the limited track record and shifting business strategies pose challenges in developing collateral performance assumptions.

CMBS: CMBS spreads started Q3 at swaps +125, rallied to swaps +100, and now trade at swaps +115. We continue to think AAA bonds offer good relative value versus other longer-duration alternatives, and we expect these AAA ratings to remain stable.

Conduit issuance is expected to be \$45 billion for 2016, which is approximately 35% to 40% lower than 2015; lower supply is supportive of spreads. Broadly speaking, commercial real estate loan fundamentals are stable, with high debt-service coverage ratios and capitalization rate premiums that are still fair to wide by historical standards.

We are concerned about the growing percentage of hospitality loans (which are more sensitive to economic downturns) and changes within the retail industry (e.g., Macy's store closures). Regardless, we believe these issues are of particular concern to specific Single Asset/Borrower deals or the mezzanine parts of the CMBS capital stack.

Mezzanine bonds bounced back in Q3, however we believe they offer a poor risk/reward proposition considering that they remain vulnerable to hedge fund weakness and murky fundamentals due to property-type selloffs and idiosyncratic loan defaults.

CLOs: We reaffirm our position that AAA CLO bonds (LIBOR +140-160 bps) continue to be one of the most attractive investments in the fixed income sector.

With credit enhancement of 35% or more, and diversification by corporate sector, AAA CLOs have robust protection from the recent credit concerns in the energy, commodity and retail sectors.

During Q3, AAA spreads tightened by approximately 10 bps. U.S. CLO issuance was \$42 billion, a decrease of approximately 50% year-over-year. Meanwhile, primary European CLO issuance was €10.1 billion, which is relatively unchanged from last year.

We believe there will be continued strong demand for CLOs managed by top-tier managers from banks (U.S. and Japan), insurance companies, and asset managers. Additionally, as 3-month LIBOR has increased, traditional "yield" investors have begun to buy as yields are now in excess of Bloomberg Barclays Aggregate Bond Index and some IG corporate indices. With that being said, we expect the market to remain range bound from L+130-145 bps for AAA bonds managed by top tier managers.

In terms of fundamentals, underlying credit in the bank loan market remains relatively stable, and we do not expect a large spike in defaults from non-commodity related sectors.

Risk retention will come into effect on December 24, and over time, we expect this requirement will lead to manager consolidation, leaving only well-capitalized firms capable of acting as collateral manager, as most risk retention capital that has been raised is manager specific. We do not expect risk retention to impede issuance.

OUTLOOK: We remain very positive on top-of-the-capital structure bonds. Negative yields in Japan and Europe could tighten AAA CMBS and CLO spreads as investors seek more yield in high quality bonds. We remain positive on GSE credit risk mezzanine cashflows, while we are negative on CMBS and CLO mezzanine tranches.

Q4 2016 Sector Outlook

Notice

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of October 2016.

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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

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