Q1 24 QUARTERLY OUTLOOK

Published January 2024

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	Total Returns (%)				
Individual FI Sectors	Q4 '23	2023	2022	2021	2020
European Leveraged Loans	1.68	13.53	-3.36	4.87	2.4
U.S. Leveraged Loans	2.85	13.04	-1.06	5.40	2.8
European High Yield Bonds	5.63	12.78	-11.13	3.32	2.9
U.S. High Yield Bonds	7.16	13.45	-11.19	5.36	6.2
European IG Corporate	5.52	8.19	-13.65	-0.97	2.77
EM Currencies	5.28	8.44	-7.14	-3.09	1.73
CMBS	5.25	5.42	-10.91	-0.64	8.11
EM Local (Hedged)	3.13	7.60	-8.85	-5.52	6.07
EM Debt Hard Currency	9.16	11.09	-17.78	-1.80	5.26
U.S. Treasuries	5.66	4.05	-12.46	-2.32	8.00
U.S. IG Corporate Bonds	8.50	8.52	-15.76	-1.04	9.89
Municipal Bonds	7.89	6.40	-8.53	1.52	5.21
Mortgage-Backed (Agency)	7.48	5.05	-11.81	-1.04	3.87
U.S. Long IG Corporates	14.01	10.93	-25.62	-4.65	13.94
Long U.S. Treasuries	12.70	3.06	-29.26	-1.13	17.7
Multi-Sector					
Euro Aggregate (Unhedged)	6.57	7.19	-17.18	-4.71	4.05
Global Agg. Hedged	5.99	7.15	-11.22	-0.15	5.58
Yen Aggregate	0.92	0.51	-5.30	-2.85	-0.8
U.S. Aggregate	6.82	5.53	-13.01	-1.39	7.51
Global Agg. (Unhedged)	8.10	5.72	-16.25	-1.54	9.2
Other Sectors					
3-Month SOFR	1.35	5.18	1.66	0.03	-1.5
U.S. Dollar (DXY Index)	-4.56	-2.11	8.21	6.37	-6.69
S&P 500 Index	11.69	26.29	-18.11	28.71	18.4

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures and full index names. All investments involve risk, including possible loss of capital. Sources: Bloomberg except EMD (J.P. Morgan), HY (ICE BofA), Bank Loans (Credit Suisse). European returns are unhedged in euros unless indicated. Performance is for representative indices as of December 31, 2023. An investment cannot be made directly in an index.

PGIM FIXED INCOME

SECTION 1

KEY CONVICTIONS & INVESTMENT THEMES

01

Pause, Pivot, Party On

We have experienced ferocious moves in rate and risk markets on the heels of moderating economic data and the Federal Reserve's pivot towards rate cuts. After market participants piled into the market as 2023 wound down—taking rates lower and spreads tighter—***a pause is definitely in order before the rally resumes, albeit likely at a slower pace.***

Still in the Strategic Buy Zone for Bonds

True, credit spreads are tighter—much tighter on high yield bonds. But yields on investment grade indices are comparable to year-end 2022 levels, and central banks are, in all likelihood, done raising rates: i.e., ***we are still at a strategic buy point for bonds.***

Fear, but not just Fear Itself

Against a backdrop of deteriorating geopolitical relations, hot and painful regional conflicts have become the order of the day. While major economies may not be impacted at present, at a minimum, a surge in energy prices represents a risk in 2024. U.S. politics—potential government shutdowns, mandatory spending cuts, and, of course, the presidential election—could return to the fore as was the case in 2016, think "taper tantrum with a negative ratings developments for U.S. Treasuries."

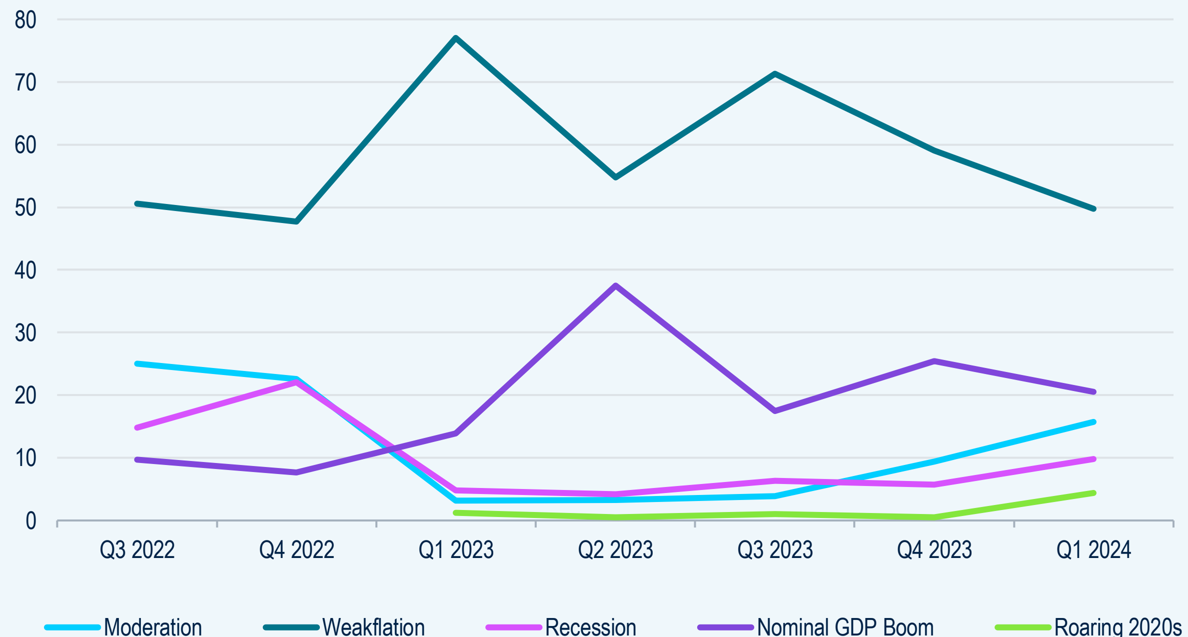
Spin to Win

In the end, 2024 may be a lot like 2023: a bull market year that leads to solid returns. But last year was about so much more. Spreads, rates, and currencies all experienced wide swings, not only presenting risks, but also opportunities to add value through diligent active management. With uncertainty high and an increased likelihood of large and repeated market swings, ***the alpha opportunity set should be broad and deep. Therefore, 2024 stands to be taxing, but ultimately rewarding, for investors.***

Over the last seven quarters, we asked PGIM Fixed Income professionals for their opinions on the most likely economic environment in the U.S. (12-months out; % of respondents)

In our latest survey, most respondents again selected "weakflation" as their most likely scenario. However, the probabilities of our other scenarios increased with the exception of Nominal GDP Boom, making the latest results one of the most disperse set of outcomes since we started the survey.

This underscores an environment of disperse views that extends beyond the distribution of spreads in certain credit sectors as indicated in the following outlooks.



Source: PGIM Fixed Income.

SECTION 2

BOND MARKET OUTLOOK

By Robert Tipp, CFA, Chief Investment Strategist & Head of Global Bonds

02

Year 1 of the Churn and Earn Bull Market; More to Come

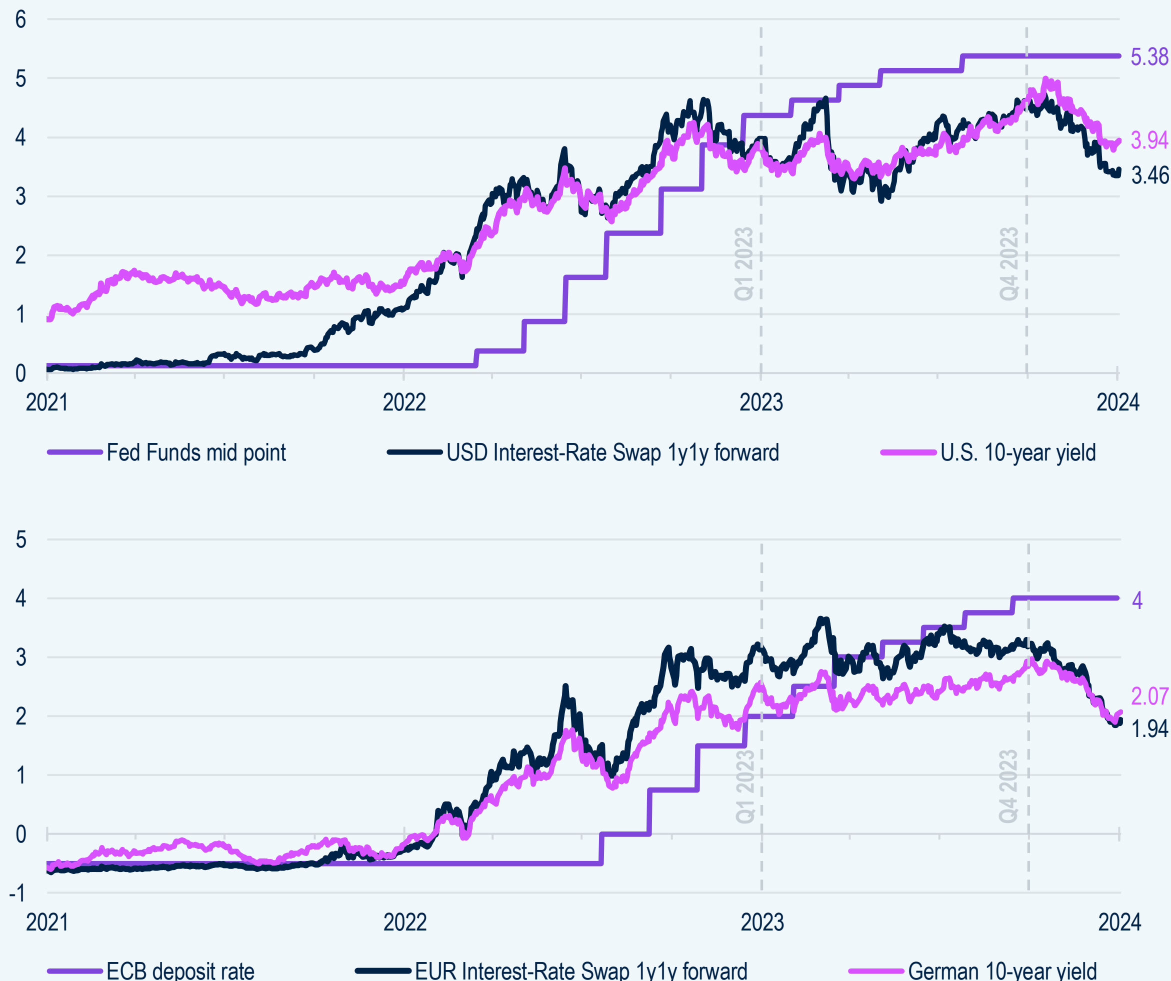
For those who doubted whether a bull market was underway, the Federal Reserve's pivot and the bond market's Q4 turnaround should have put those doubts to rest. Long-term rates in Western bond markets appear to have passed their peak for the cycle with the vault to new cycle highs in October 2023 marking the end of the bond bear market. So, what's next?

Fortunately, once yields have etched out the top of the range and central bank rate hike cycles have concluded—as we believe they have in the major Western markets—what comes next isn't complicated. As we suggested a year ago in our blog post "Yield is Destiny," once yields reach respectable levels, which they did and where they remain, bonds will "Churn and Earn." Yes, there will be quarter-to-quarter volatility, but over the decade to come, long-term fixed income investors should see these elevated yields manifest as elevated returns. In short, **we remain at a strategic buy point for bonds**.

Near term, as highlighted in the following section on developed market interest rates, **some consolidation or reversal of the recent, stunning drop in rates (Figure 1) may be in order**. Given the recent market pricing of aggressive rate cuts over the next 12-24 months (200 bps or so in both the U.S. and Eurozone,

Figure 1

Long-term rates plunged in Q4 as investors took the Fed's pivot message on board (top graph). Seemingly without regard to the variations across economies, similar price movements were seen in many key Western markets (bottom graph). The accompanying charts show that short term interest-rate expectations priced in roughly 200 bps of rate cuts over the next 12-24 months—i.e., cash spot rates are roughly 200 bps higher than their respective forwards. (%)



Source: PGIM Fixed Income and Bloomberg.

for example) markets will be vulnerable to any higher-than-expected growth or inflation readings. As noted in our Economics section, U.S. rate cut projections moderated following the December payroll report.

Similarly, credit spreads tightened dramatically as 2023 came to a close (Figure 2), leaving the **potential for spread widening early in the new year as the market digests its gains**.

As 2024 commences, heavy government and corporate issuance may weigh on the market. However, as central banks move towards rate cuts over the course of the year, the market's technical backdrop should improve. Money fund balances surged in 2023 as a result of the inverted yield curve and high cash yields. Additionally, the bear market in bond valuations and outflows has reduced bond allocations, while rising equity prices have boosted equity allocations.

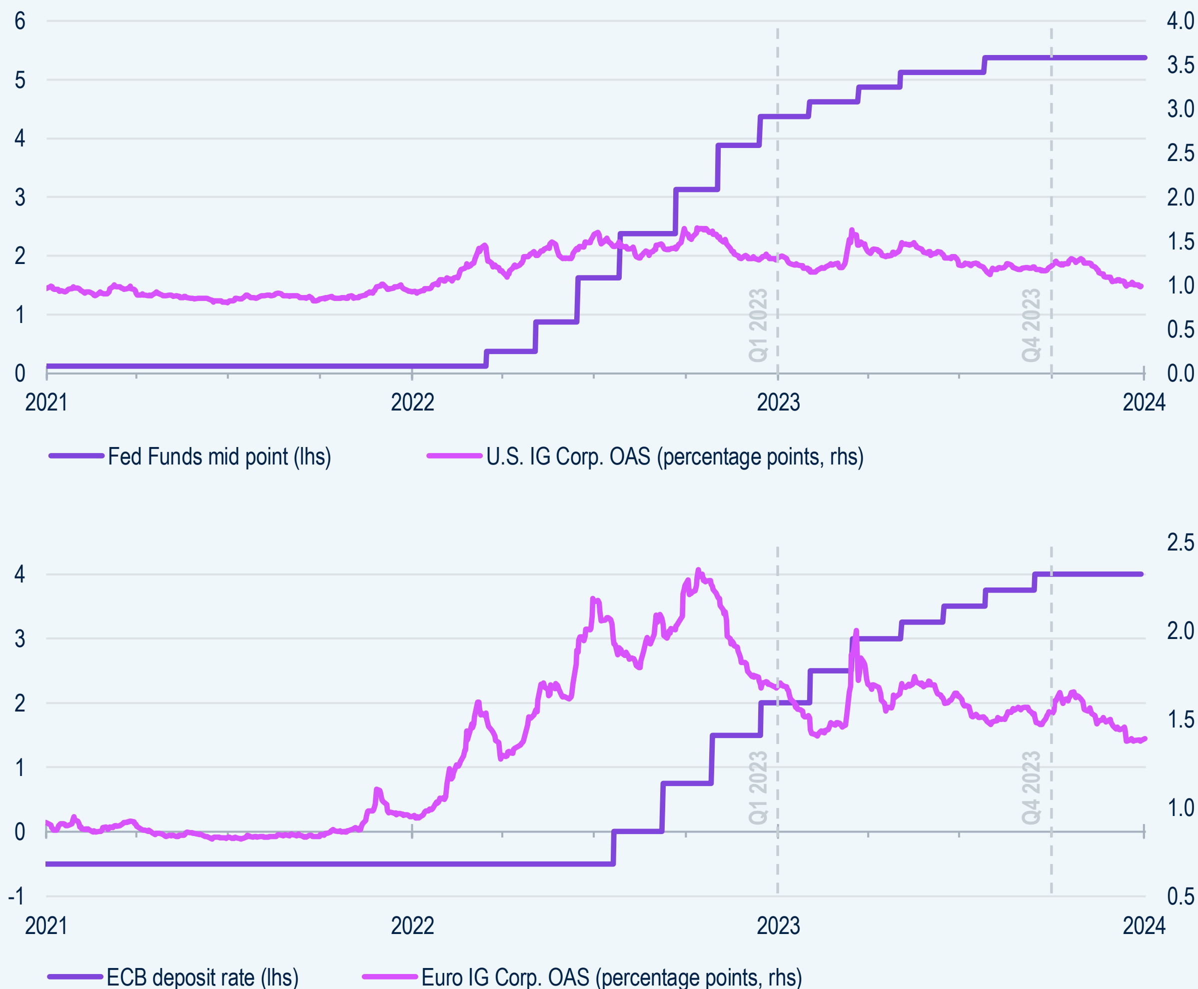
In short, once central banks begin to cut rates, the stage may be set for the mother of all asset allocation trades should investors seek to normalize their portfolio mix by shifting from both stocks and cash to bonds.

BIG PICTURE REFLECTIONS

Before wrapping up our outlook summary, let us digress briefly with a few bigger picture reflections (and speculations), focusing on more structural turning points and potential watershed events.

Figure 2

Corporate spread widening ended in 2022 as central banks reduced their pace of rate hikes. An improving trend since Q1 2023 accelerated in Q4 with the DM bond market rally and Fed pivot. This rapid spread compression may leave IG corporate spreads susceptible to short-term widening. But longer term, supportive fundamentals and a healthy supply/demand balance should contribute to positive performance.



Source: PGIM Fixed Income and Bloomberg.

1. Negative Rates—The End is Nigh

The Bank of Japan is widely expected to end its negative-rate policy in early 2024, closing a dark chapter for global bond investors and economies: a period when, ironically, policy makers burned the money of savers and investors in the hopes of boosting economic sentiment and thereby encouraging consumption and investment.[1] In future crises, will central bankers stop their policy easing at zero, thereby avoiding the unintended destructive side effects of negative rates?

2. End of the Euro Crisis

After flouting its self-imposed fiscal rules, the Eurozone experiment fell on hard times a decade ago. In response to Greece's default, governments tightened fiscal policy pro-cyclically, creating a grinding headwind for their floundering economies. While we doubted the predictions of a Eurozone breakup, we nonetheless envisioned a prolonged stretch of subpar growth that would require an extended period of ultra-low rates and monetary accommodation.[2]

Fast forward to Q1 2024: The ECB's cash rate is up to 4% and Europeans have just remodeled their fiscal rules—the so-called Stability and Growth Pact—to increase flexibility in an effort to maintain fiscal discipline over the long run, but without the unrealistic standards and pro-cyclical mechanisms of the original pact. And Greece provided the icing on the cake: previously the poster child for fiscal distress, the peripheral country completed a roundtrip back to investment grade with rating upgrades during the fourth quarter. Is the current system perfect? By no means, but the bloc's monetary and fiscal policies have come a long way with the creation of structures designed to mitigate the downside risks that materialized in 2009-2012.

3. Fossil Fuels "A"—An End to the Gas Squeeze?

First, with regards to natural gas, in the wake of the war in Ukraine, sanctions on Russia, and soaring gas prices, Europeans have broadened their natural gas sources and have kept storage levels high. While energy prices remain above pre-2022 levels, the vast majority of the 2022 surge has been reversed (Figure 3). With winter's arrival and European industrial gas demand remaining depressed it may be too early to say, but it's at least worth noting and asking the question: is the squeeze over?

[1] For more on this dynamic, see "From Low Ranger to High Plains Drifter," PGIM Fixed Income, August 22, 2023.
[2] For additional information on this period, see "Europe: Into the Void," PGIM Fixed Income, October 2014.

Figure 3
Natural gas prices may continue to moderate as Europe expands its sources and maintains elevated storage levels. (EUR/MWh)

Source: PGIM Fixed Income and Bloomberg.

4. Fossil Fuels "B"—From No Future to Yes, a Future?

In recent years, renewable energy production has been intermittently—but decisively—thwarted by natural phenomena: droughts interrupting hydroelectric generation, lulls in the wind halting turbines, and clouds hindering solar. When these events occurred, they negatively affected economic activity and resulted in soaring energy prices and a profit boon to fossil fuel investors.

While COP28 supposedly signaled a "Beginning of the End" of the fossil fuel era, which it may still become, the meetings (hosted by Dubai in the oil producing Middle East, attended by a swarm of fossil fuel lobbyists, and major energy chieftains) perhaps gave a more pragmatic impression. Despite the projected decline in fossil fuel production over time, demand will remain strong over the near-to-intermediate term as fossil fuels are a key enabler of rapid growth in emerging market economies. Furthermore, even if and as renewables become the principal source of energy, an extensive fossil fuel production capacity may remain a necessity as a supplement and backup for renewable power generation.

BOND MARKET OUTLOOK

The Benefit of Bonds, Despite an Inverted Yield Curve

For now, with cash rates still high, the question we addressed last quarter lingers for many investors: with the persistence of flat to inverted yield curves and market volatility, why bother with bonds at all?

- **Alpha**—Just like the year past, the fixed income market continues to offer opportunities in all areas to add value through active management, including term structure positioning, sector allocation, local EM rates, and FX.
- **Credit beta**—Despite the fourth-quarter's compression in credit spreads, exposure to credit beta should continue adding value as central banks shift towards easing policy rates.
- **Long-term income hedge**—If the past is prologue, one day investors will wake up to find that an unexpected shock has forced central banks to cut rates to zero, bringing rise to the adage true for so much of this century when central bank rates rested at the effective lower bound: "cash is trash." In that event, investors who failed to lock in higher rates will end up losing out in the long run.
- **Potential risk hedge**—Furthermore, in a risk off event—such as the SVB crisis in the Spring of 2023—government yields may fall, providing ballast to a portfolio's total return potential.
- **Relative valuations**—Following central banks' post-COVID rate-hiking cycles, long-term yields are attractive: bonds have revalued. On the other hand, equity valuation measures, such as price earnings multiples, appear somewhat stretched. With valuations comparatively extended, stocks may be vulnerable to a repricing due to either an economic slowdown or an increase in interest rates.

The Bottom Line

With Western central bank cash rates cresting, the fixed income bull market is underway. While a rest may be in order following the fourth-quarter's sharp rally, long-term expected returns appear strong, supported by respectable yields and the range of opportunities to add value through active management.

Check out more of PGIM Fixed Income's latest thought leadership and media spotlights at PGIMFixedIncome

WHITE PAPER

FROM NICE TO VILE—THE FUTURE OF INFLATION

We explore the type of inflationary environment that we might expect across developed markets in the future and its potential effect on global asset prices.

RESEARCH HUB

INTEREST-RATE SENSITIVITY ANALYSIS

As the global economy transitions away from the era of Great Moderation, our series reveals that the evolving interest-rate sensitivity of the U.S. economy is yet another aspect of the emerging paradigm that carries significant investment ramifications.

PODCAST

REALITIES IN RATES

A discussion on the end of the hiking cycle, the impact of fiscal deficits on long-term rates, and the interplay between rates, curve shape, and the economy.

SECTION 3

GLOBAL MACROECONOMIC OUTLOOK

By Daleep Singh, Chief Global Economist & Head of Global Macroeconomic Research

03

Transitory Truths Reveal the Paradigm's Next Phase

If central banks' urgency to return inflation to their respective targets encapsulated an underlying theme of the global economy in 2023, early 2024 starts with assessing the ramifications of their initial success. It's a fitting time to take stock: after years of collectively fighting a bout of inflation now seen as transitory with the benefit of hindsight, policy paths, economic trajectories, and fiscal roles amongst the word's largest economies appear set to splinter.

This subsequent phase of the paradigm framing the global economy can benefit specific regions and countries through more individualized approaches. Yet, newly divergent paths may also fuel periods of volatility as the latest cyclical developments interact with the paradigm's more secular forces.

Although the Federal Reserve and the **U.S.** economy may be leading this divergence, the Fed's shift was enabled by its clinical progress against inflation, culminating with the December PCE report. The Fed's favored inflation measure showed the first monthly decline in prices since April 2020, and our preferred view of inflation on a three-month annualized basis decelerated to 2.9%, which is within the prevailing, pre-COVID range. For those keeping tabs on when core inflation may reach the Fed's 2% target, if the monthly core PCE readings continue to average 0.2%, the target may be reached before midyear 2024 (Figure 1). And this is before the full effect of slowing rents emerges in the data.

However, the step of precisely hitting an inflation target is increasingly moot: with the benefit of hindsight, the bout of inflation appears transitory, just not to the brevity many initially anticipated.

While the Fed pivoted at the December FOMC meeting with its median projection for an additional two 25 bps rate cuts in 2024 and 2025, which would bring the Fed funds rate to 4.6% and 3.6%, respectively, it maintained a semblance of vigilance against inflation by maintaining its 2026 and long-run rate projections. We continue to expect that the Fed may lift its long-run estimate closer to 3.0%, perhaps at a future Jackson Hole symposium.

As is custom, markets bit down on the Fed's projected rate cuts, pricing in about 75 bps of policy easing through June 2024 in the immediate aftermath of the the healthy December payroll report. Yet, we don't think the Fed will be as quick to turn its back on inflation, and our expectations largely remain unchanged since mid-2023 as we see three 25 bps rate cuts starting in Q2 2024.

As the inflation threat fades, additional focus will undoubtedly turn to the balance in the U.S. labor market. For example, in 2021, demand for labor exceeded supply nearly eightfold. Since then, workers

Figure 1

The subjectivity of "transitory" as U.S. Inflation approaches the Fed's target. (Core PCE (Y/Y) evolution based on M/M scenarios (Y/Y %))

Source: PGIM Fixed Income and Macrobond as of January 2, 2024.

returning to the labor force—boosted by immigration and female labor force participation—lifted labor supply to the point where it now easily exceeds demand. As economic growth moderates and companies experience reduced pricing power, elevated wage pressures pose an increasing risk to the labor market over the coming year.

However, we also see the potential for higher labor costs to incentivize innovation and productivity amongst employers as they adjust to improve competitiveness. Furthermore, increased public incentives for capital expenditures in various sectors provide a structural productivity catalyst on the supply side, which is most visible in the real construction spending across technology-related industries. While the productivity uptrend may slow over the coming 12 months amid Washington's looming policy paralysis, we're optimistic that the uptrend will resume over the coming three to five years if related policy decisions are made prudently.

This year also brings more than its fair share of political developments that risks propagating an increasingly familiar theme in the U.S. With stopgap funding measures expiring at the end of January/early February, the U.S. again faces the threat of a Federal government shutdown. Based on prior experiences, for each week that the Federal government is closed, current quarter real GDP may contract by 20 bps. While markets may remain sanguine on the prospects of government shutdowns until the 11th hour—perhaps with an understanding that GDP drawdowns may be recovered during the quarter after a reopening—another political showdown will again place Washington's growing disfunction on display for allies, adversaries, and rating agencies.

This is to say nothing of the presidential election cycle, complete with its array of global ramifications. At this point, the implications of the U.S. Presidential campaign and election—as well as other key elections in India, the European Union, Indonesia, Mexico, the UK, and Taiwan—will come into focus in the months ahead, and we'll address the potential economic effects in subsequent publications.

While the preceding points (amongst others) leave plenty to consider this year, our U.S. economic scenarios remain unchanged from Q4 2023 as we continue to see weakflation as our base case (35%), followed by a 25% chance of a recession. Our scenario assumptions include tight monetary, fiscal, and credit conditions that slow cyclical momentum to below trend growth of about 1.6% vs. an estimated 2.1% in 2023 (visit the Appendix for more on our global economic scenarios).

Turning to **Europe**, the Fed's projected pivot and its respective implications starkly contrast the ECB's approach to preserve its policy optionality going forward, particularly amidst the expected fragility of European growth this year. Although President Lagarde clearly indicated at the latest policy meeting that it was too soon for the governing council to discuss rate cuts—thus projecting the status quo—the ECB's announced adjustments to its Pandemic Emergency Purchase Programme (PEPP) ran counter to prior statements. On the surface, the plans should lead to an accelerated run-off of its balance sheet in the second half of 2024 and contribute to tighter financing conditions in the euro area. Yet, the PEPP announcement also suggests that—if the facts change—the ECB could nimbly react by adjusting policy rates now that it addressed the PEPP runoff. With that context, the ECB will likely wait to see lower inflation prints beyond certain services sectors, such as transportation, weaker readings in wage-sensitive sectors, such as recreation, and less buoyant profit margins before gaining the confidence to disclose deliberations about rate cuts. As Lagarde emphasised, this evidence would only be available after the first half the year, and our base case assumes rate cuts would return the deposit rate to 3.5% (4.0% currently) by Q4 2024.

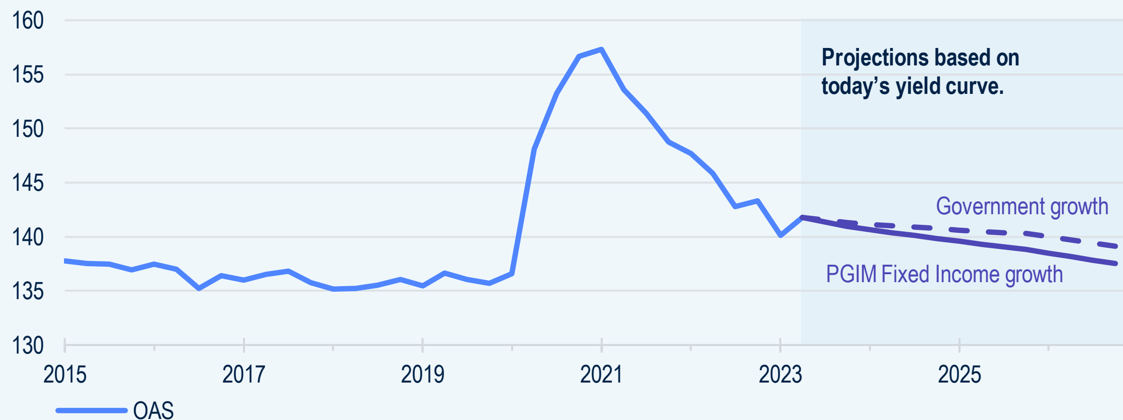
The prospect for fiscal stimulus is another point of divergence between the U.S. and Europe. In fact, we see it as a wildcard in terms of future growth in the euro area. Indeed, the pending introduction of new European fiscal rules appears set to provide some discretion when it comes to rule implementation, and applying a new set of punitive measures would fall to future governments, rather than those that negotiated the framework. With Italy's economy among the most fragile in the bloc, the new measures may provide the country with a couple of years to boost growth—likely through prudent spending of its New Generation EU funds—in an attempt to maintain the downward trajectory (albeit slight) in its debt-to-GDP ratio (Figure 2).

Considering the ECB's maintained optionality and the region's sizable fiscal role, weakflation also remains our base case for the euro area (unchanged at 40%) as we expect GDP growth of 0.5% in 2024. While our recession scenario for the Euro Area (up from 25% in Q4 2023 to 30%) is not our base case, it includes a sharp deterioration in economic activity that would prompt the ECB to cut rates into the 2% area this year.

We anticipate that fiscal developments will also continue to play a role in **China** this year as authorities aim to steer the world's second largest economy between short-term goals to stabilize growth amidst persistent deflation and longer-term objectives to deleverage vulnerable sectors, such as real estate. Indeed, China's November inflation reports showed ongoing deflation at the consumer and producer levels (Figure 3), which is consistent with economic data indicating subdued lending activity to corporations and households. Thus, authorities are targeting stimulus at local jurisdictions, and that effort via debt issuance resulted in five consecutive months of increased total social financing in the latter stages of 2023. This development also involved the first use of central bank financing, which may expand through the first half of 2024 as authorities seek to revive inflationary momentum. As this stimulus fades, it could be offset by the long-awaited revival of activity in the real estate sector.

Figure 2

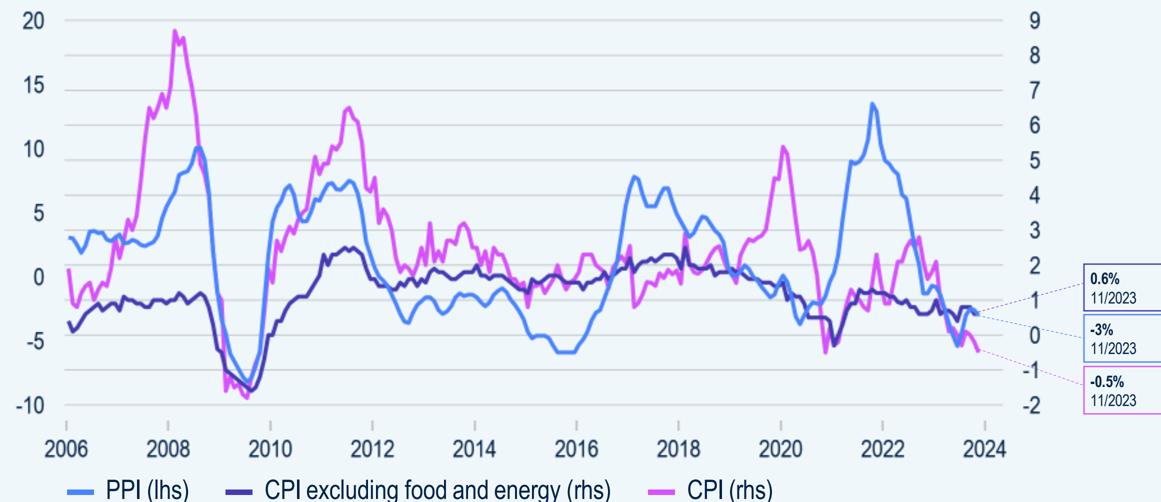
Sound spending of NGEU funds could keep Italy's debt-to-GDP trending lower. (Italy debt-to-GDP ratio, % of GDP)



Source: PGIM Fixed Income, Macrobond, and Italian MEF as of January 4, 2024.

Figure 3

Where is inflation when you need it? China's protracted deflationary conditions (China CPI and PPI, Y/Y %)



Source: Macrobond as of November 2023.

When looking ahead, China's combination of long and short-term dynamics leaves us with three key points to watch. First, it's evident that authorities' policy mix is doing more to stimulate the supply side than the demand side, hence the country's falling prices. Therefore and second, China's demand impulse to the global economy will remain marginal (the country is 30% of global manufacturing, which could expand further with additional investment stimulus) and implies headwinds for major exporting regions, such as Europe. That said, the prospects for increased central bank financing at least offers the prospect of easing global goods deflation. Third, from a structural perspective, China's economic imbalances remain unresolved—e.g., investment as a share of GDP among large economies remains the highest in the world (far too high to be productive or profitable)—thus, deleveraging, demographics, and de-risking will remain a drag on long-term growth.

As a result, we expect China's growth to continue slowing to about 4.5% this year from an estimated 5.3% in 2023. Therefore, we continue to see a soft landing/moderation scenario as our base case for China with the probability rising from 45% to 55% at the cost of low-growth scenarios. However, beyond this year, we expect growth to moderate further to an approximate ceiling of 3% over the medium term.

As China navigates between its short and long-term challenges, its economic direction will continue to exert significant influence across **emerging markets** (see the EM section for more on the sector and the Appendix for our Emerging Market scenarios).

This year may also see developments with the **Bank of Japan** and whether its policy rate finally moves out of negative territory and converges towards those of other major developed market central banks. In our base case, the BoJ will take a patient approach to policy normalisation until it sees the evidence of inflationary dynamics at 2% baked in the data. Therefore, the BoJ may not lift rates out of negative territory until the second half of 2024, but even in that case, it is unlikely to take rates beyond zero.

These outcomes underscore the newly divergent paths that central banks and economies will find themselves on in 2024. As countries embark on this new phase of the paradigm, they are subject to the previously referenced effects of the shifting, structural anchors under the global economy. Thus, as much as conditions may change in 2024, the role of these secular factors in influencing the long-term performance of the global economy cannot be overlooked.

SECTION 4

GLOBAL SECTOR OUTLOOKS

04

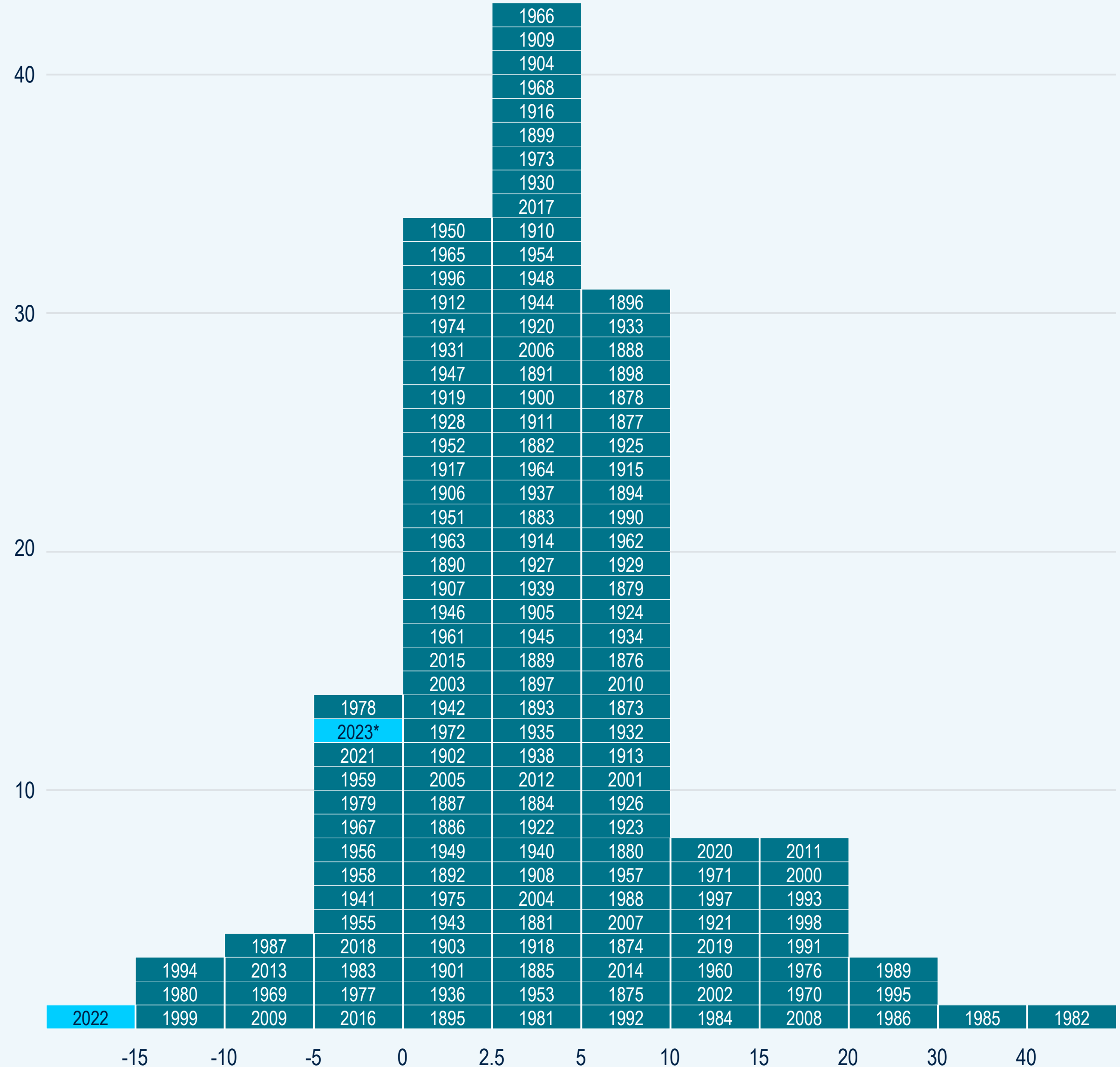
DEVELOPED MARKET RATES

Outlook: Ample tactical opportunities amidst historically wide trading ranges. As the momentum behind the Q4 rally dissipates, U.S. rates may revert higher, while European and UK rates remain in a tighter relative range. Spring wage negotiations will be key for the BoJ and whether its policy rate moves out of negative territory.

- If investors dared to blink as 2023 drew to a close, they likely missed a cycle-worth of moves in just a handful of days. The scale of the moves can be disorienting, but maintaining a long-term perspective on appropriate trading ranges opens the door for tactical, alpha-generating trades across the developed market rate universe. With the specific drivers of the move covered in our Economics and Markets sections, we'll generally maintain a market focus, including a view that DM rates are unlikely to set new cycle highs in the months ahead.

- The rally that dropped the U.S. 10-year yield from 5.0% to a 3% handle in a matter of weeks likely established the boundaries for what will be a historically wide trading range. A sizable portion of the trades in late 2023 reflected investors' year-end adjustments, thus the rally may soon near exhaustion given the market's tendency to overshoot vs. fundamentals.

10-year Treasury Bonds—Total Return Distribution
(%, # of years)



Source: Alpine Macro as of December 1, 2023.

- As the late-year rally continued, we reduced our long-duration exposure to roughly flat. The market's aggressive pricing of Fed rate cuts in 2024 resulted in a highly convex yield curve, and the three-year point appears expensive versus the front end, i.e., moving in from the 5-year point towards the 2-year point appears to be an expensive proposition. That valuation context increases the probability of approaching positioning from the short side in the coming months.

- Given our tactical approach, we remain cognizant of factors that could quickly take rates in either direction. Indeed, a selloff scenario could be driven by pro-cyclical fiscal stimulus (if Washington's paralysis clears) with early signs of higher rates sparking a pseudo Taper Tantrum and a jump to even higher levels. Indigestion of heavy Treasury supply amid the Fed's ongoing quantitative tightening process could also push rates higher, and signs of buying fatigue will be closely monitored in upcoming auctions. Deteriorating conditions in the Middle East and a consequent lift in crude oil prices could also rekindle some inflation fears.

- Conversely, the rally could extend with another non-inflationary economic shock and/or weaker than expected economic conditions that prompt the Fed to ease policy in line with, or beyond, current market pricing.

- The U.S. also begins 2024 with a structural development that we've frequently discussed. The SEC's newly passed mandate to centrally clear Treasuries trades by certain entities and all repo trades will likely increase costs in the Treasury market as well as require a buildout of repo clearing infrastructure. While the mandate includes an extended runway through mid-2026, we see this as an appropriate length of time given the importance and industry buildout required for the implementation.

- In Europe, just as the ECB and the BoE diverged from the Fed by maintaining their policy optionality, we see a similar, but nuanced, divergence in the rates markets. While rates across Europe and in the UK may have dropped ahead of their respective fundamentals, they may stall around current levels, but not necessarily with a notable correction higher.

- Meanwhile, Japan's interest-rate outlook appears dependent on the course of the yen, which is a key consideration in the market's domestic inflation forecast and the policy course for the Bank of Japan. The BoJ might move policy rates out of negative territory—perhaps in Q2 2024—with additional information from the Spring wage negotiations. Therefore, at this point, the JGB market may also be slightly expensive relative to potential risks to the upside.

AGENCY MBS

Outlook: Cautious in the near term. Although we're cautious after Q4's sharp spread tightening, our long-term view of the sector and its potential excess returns remains positive. We continue to favor specified pools, while underweighting production coupons (30-years, 6% and higher). The convexity profile of recent production has deteriorated further with conforming loan limits rising again; those buyers may quickly refinance into lower mortgage rates.

■ The whirlwind rally of Q4 2023 saw the MBS sector notch significantly positive excess returns. While longer-term valuations remain attractive, we are proceeding carefully to begin 2024 given the magnitude and speed of the sector's recent rebound. Additionally, the end of the Fed's hiking cycle and the reduced optionality around future policy moves (see DM Rates section) could produce some interest-rate volatility over the near term. Longer term, however, once the Fed has remained on hold for a prolonged period or fine-tuned policy rates, volatility should subside, thus benefitting the MBS sector.

■ While the interest-rate rally also dropped primary mortgage rates from 23-year highs, we don't expect an immediate influx of supply beyond a seasonal increase in activity. After all, from a longer-term perspective, the lack of affordable housing units in the U.S. remains a headwind for purchase loan activity.

■ Additional positives to start 2024 include the potential for revived bank demand as deposit pressures ease as well as Treasury's ongoing, heavy issuance that could prompt moments of indigestion as the Fed's quantitative tightening process continues. The latter, technical factor could contribute to further positive excess returns for the MBS sector.

■ Although prepayment activity has remained muted given primary mortgage rates, it bears watching as the new year begins following the extended decline in interest rates in late 2023. If rates moderate around current levels, we anticipate higher coupons will exhibit faster prepayment speeds as borrowers in these mortgages take advantage of lower primary rates.

■ This dynamic also underscores a somewhat more limited opportunity set within the sector. With convexity risk building in production coupons, investors will collectively shift their focus to more positively convex opportunities in lower coupons. We also see limitations in TBA dollar rolls as they still do not trade special, making them inferior to owning specified pools.

■ The last potential headwind is the Fed. If prepayments spike in higher coupons, it's unlikely the Fed would restart quantitative easing with MBS, thus making the Fed's balance sheet unavailable to absorb prepayment activity. Furthermore, if the Fed backtracks on its rate cut projections, it would likely lead to another bout of volatility across risk assets.

MBS Spreads Returned to Q1 Levels After the Sharp, Year-End Tightening.
(bps)

Source: PGIM Fixed Income and Bloomberg.

The Fallacy of "Net-Zero by 2050"

Investors with ESG objectives may seek to construct portfolios consistent with the Paris Agreement goal of limiting global warming to less than 2°C. In attempting to do so, the typical approach is to set a net-zero target based on a portfolio's carbon footprint, weighted average carbon intensity, or similar metric. Investors may find this appealing due to the simplicity of using a single metric that can ostensibly track performance and facilitate comparisons across portfolios. However, similar to many ESG topics, a simplistic approach fails to capture critical nuances, which are inevitable in a process as complex as assessing an issuer's impact on climate change.

For instance, a single, portfolio-level metric often results more in sector rotations than in efforts to organically decarbonize. Sector rotations can be highly counterproductive as companies in emissions-intensive industries, such as steel and utilities—which currently need to make the most significant upfront investments to decarbonize—face higher capital costs, while companies that contribute little to real-world decarbonization, such as financials and software, may benefit from lower capital costs. This incentivizes emissions-intensive companies to double-down on "brown" activities that require less capital today, consequently delaying investments in their respective transitions.

The push to create a "standard" metric for all asset classes is equally problematic. In many asset classes—such as sovereigns or structured products—a carbon footprint approach ignores considerations critical to any reasonably accurate assessment of decarbonization performance.

For example, the most common approach to calculating "carbon footprint" for sovereigns is to calculate the greenhouse gas (GHG) intensity of GDP. This metric is woefully inadequate. For starters, a quick analysis shows that many countries with low GHG intensities of GDP have some of the highest emissions per capita, which immediately calls into question the effectiveness of the metric. More importantly, the UN has been clear from the start of climate negotiations in the early 90s that countries have differentiated responsibilities. The appropriate decarbonization trajectory for a given country depends on both its historic responsibility for warming (which is a result of cumulative emissions to date, not just emissions in the current year) and its capacity (in terms of financial, technological and natural resources).

GHG intensity of GDP also ignores critical impacts countries have on global climate change beyond their borders. For instance, experts have made abundantly clear that an absolutely crucial aspect of developed countries' climate responsibility is to provide a significant amount of "highly concessional finance" (see the COP28 declaration) to fund developing countries'

PODCAST

COP28: DISSECTING CLIMATE PROGRESS AND PLEDGES

A review of the takeaways from COP28, the United Nations Climate Change Conference hosted in Dubai, UAE.

PODCAST

A GROWING GAP: EXPLORING PROGRESS ON GLOBAL DECARBONISATION

An examination of the latest developments in global climate action and how things are measuring up against what is necessary to limit warming to 1.5°C.

Check out more ESG thought leadership and media spotlights at PGIMFixedIncome

transitions. This is essentially equal in importance to developed countries' own, domestic emissions reductions efforts. Unless this concessional financing is grown by many multiples of its current levels, there is little chance of limiting warming to anything close to 2ºC. And these nuances are just a few of many. The more one digs into the climate impacts of sovereigns, the more obvious it becomes that GHG intensity of GDP is simply not fit for purpose.

In the case of structured products, a single metric is also problematic. In many structured product sub-types, there are KPIs that could be used to evaluate climate performance, such as those pertaining to the energy efficiency of buildings or the energy ratings of a pool of auto loans. However, rather than simply evaluate these KPIs as they are—limitations and all—there is a push to "convert" them into "carbon footprints." This is done through arbitrary transformations of the KPIs that create proxies for carbon footprint (e.g. multiply energy efficiency ratings by a pair of constants representing standard assumptions for energy use and emissions intensity of energy). While this neatly creates a "carbon footprint," it waters down the precision of the underlying KPI and is often so imprecise as to be borderline misleading (especially since the margin for error in these assumptions is rarely disclosed or discussed, except possibly buried in fine print).

The supposed benefit of a single metric is that it allows users to combine the "carbon footprint" of many asset classes together to permit cross-asset-class comparisons and tracking. But again, the proxies used for carbon footprint in many asset classes are highly imprecise and reduce key considerations into arbitrary assumptions. So in reality, these proxies are more incomparable than not. For instance, would a 10% reduction in carbon footprint by a steel company, a software company, an emerging market sovereign, and a pool of auto loans, all actually have the same real-world climate impact? Given that single point metrics fail to account for some of the most crucial considerations in measuring climate performance, their value in assessing real world decarbonization is questionable.

By comparison, our use of a wide array of metrics and assessment tools, including qualitative evaluations, is designed to capture more of these critical nuances. Rather than a number, the primary output of our approach is a temperature alignment category or rating.

One such nuance is an issuer's future-emissions profile, and establishing this view goes well beyond accepting issuer pledges at face value. Indeed, our approach not only involves evaluating the credibility of issuers' pledges, but it also includes assessing the pledges' alignment with the relevant temperature pathways. Shifting back to the portfolio level, our approach accounts for the materiality (or lack thereof) of each issuer's emissions, rather than treating all issuers in a portfolio as equally important when their real-world impacts are anything but equal.

We take these steps recognizing that "net zero by 2050" is not the appropriate target for each issuer, and that the goal of 1.5°C or even 2°C will be impossible without a meaningful, imminent step up in ambition, rather than action in 10, 20, or 30 years from now. Unless more is done today, pledges for 2050 will mean little.

Given the separation between theoretical and realistic approaches, our emphasis on the latter does not lend itself to a simple, single number output. But as we'll continue to demonstrate in upcoming research this year, our approach to temperature alignment provides a comprehensive view to an increasingly complex issue. And progress on the issue may only be possible if solutions address the myriad nuances throughout real word conditions.

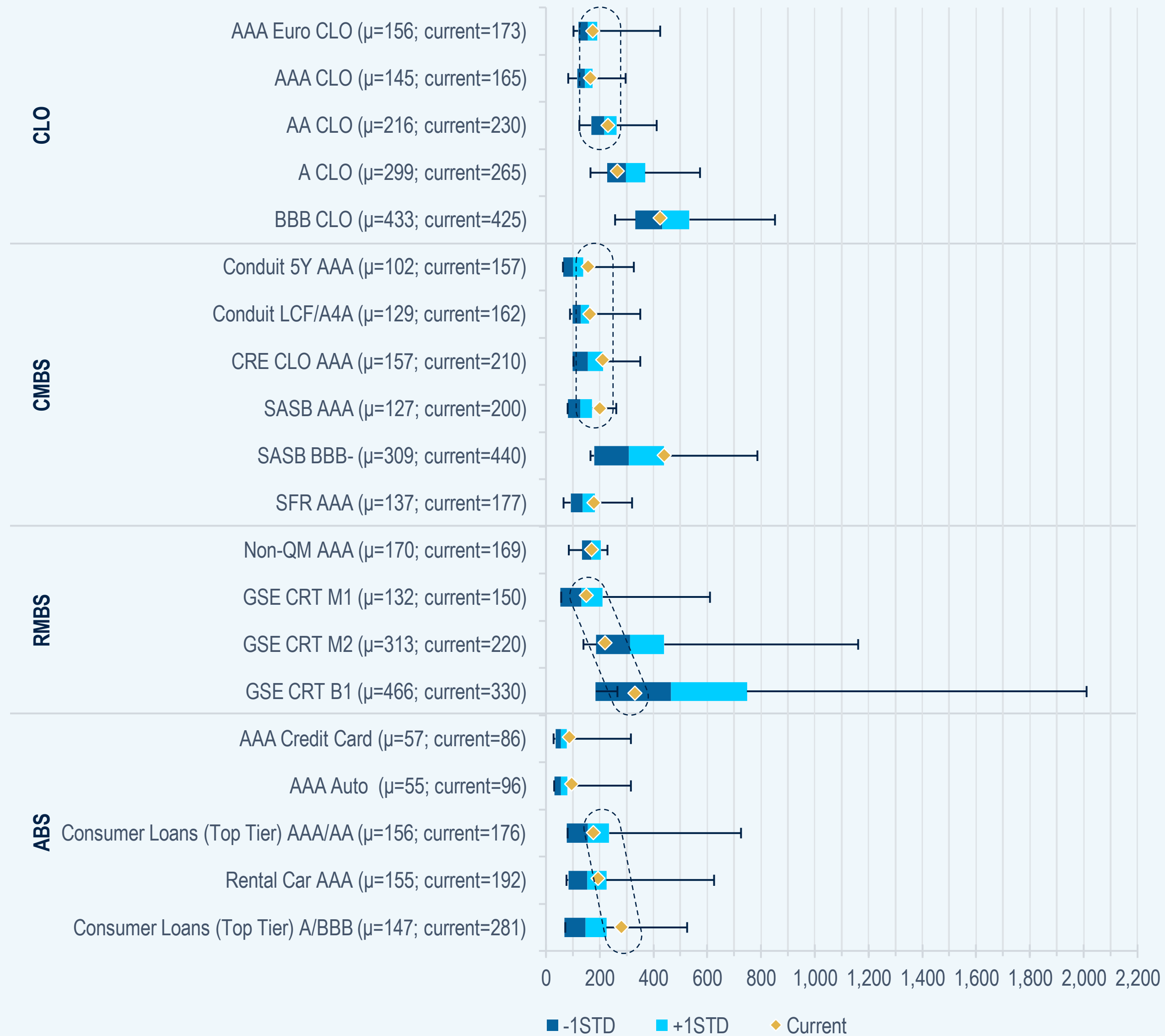
SECURITIZED CREDIT

Outlook: Senior tranches remain attractive, selective on credit. We continue to favor senior tranches given their attractive risk-adjusted returns and robust structural credit protection, but believe spreads at the top of the capital structure will remain rangebound, making carry the dominant theme in 2024. Further down the capital stack, we are biased toward wider spreads as the recent rally—coupled with weakening fundamentals—could weigh on the most levered tranches. We remain patient and positioned in shorter spread duration assets at the top of the capital structure, while staying extremely selective and tactical on more credit-sensitive investments.

- In **CMBS**, higher interest rates have led to softness in capitalization rates, which pressured valuations in 2023, and we expect this to continue in 2024. Our expectation going forward is that property values will generally decline by about 20%, but dispersion will abound with office likely to do the worst. Despite these challenges, we see value in AAA conduit bonds, which now trade wider than corporates, and select single-asset single-borrower securities. Higher interest rates and a more challenging financing environment are expected to keep issuance suppressed.

- Home prices continue to benefit from strong technicals as existing homeowners with low mortgage rates stay in their homes. We remain constructive on **RMBS** performance,

Valuation perspective in securitized credit
(spreads in bps; μ refers to the set mean)



Source: PGIM Fixed Income

particularly credit risk transfer bonds backed by higher-quality, GSE seasoned collateral, but acknowledge mortgage delinquencies have ticked up slightly in FHA and non-qualifying mortgage pools—two of the lowest credit-quality segments of the mortgage market.

- While bank loan spreads have been supported by low loan supply and strong demand, we expect to see some credit deterioration in the underlying **CLO** collateral via downgrades to CCC, increased default rates, and lower recovery rates. We expect higher interest costs to pressure loan issuers' free cash flows, leading to negative credit migration and more price volatility. Thus, we continue to favor senior CLO tranches (AAA and AA) in the U.S. and in Europe.

- In **ABS**, prime consumer credit remains resilient, while the effects of inflation and lower disposable income continue to weigh on the weakest consumer segments. Some specialty ABS lenders were caught off guard by rapidly rising rates and higher-than-expected defaults, underscoring the importance of originator/servicer due diligence. We remain positive on spreads in the near term as ABS plays catch-up to the broader markets and the reduction of new issue volume continues to assist dealers towards reducing inventory. Looking forward, we expect increased banking regulation to lead to more opportunities via asset sales or regulatory transactions (i.e., significant risk transfer).

INVESTMENT GRADE CORPORATES

Outlook: We expect U.S. investment grade corporate spreads to remain rangebound between 95-125 bps in 2024. Performance will likely be driven more by carry than by spread tightening. In this environment, credit selection takes on additional importance—i.e., alpha is likely to come from names not owned versus those that are. We believe attractive yields, as well as strong fundamentals and technicals, will support the sector going forward.

- First and foremost, inflation is still above the Fed's 2% target, but slowly trending in the right direction. We expect U.S. economic growth to slow in the first half of 2024 but, thus far, it has been resilient in the face of higher borrowing costs. Further slowing of global growth this year could pose a headwind for companies with large overseas exposures.

- Given our economic outlook and the relatively conservative behavior of management teams, we do not anticipate many fallen angels in 2024. However, revenue and earnings growth could face more challenges in 2024. Current consensus estimates appear optimistic as the U.S. consumer spending has been resilient amid higher interest rates and elevated inflation, but there are signs of weakness emerging. While the strength of the labor market has allowed consumers to keep spending, we believe the demand for workers is off its peak. Therefore, companies are more likely to experience limited pricing power, while still needing to absorb higher labor costs.

- The health of the banking system (especially the regional banks) has been a major theme since SVB's collapse in March 2023. After two additional earning seasons, banks' deposit outflows have mostly stabilized, but deposit costs have increased, albeit not to the point of concern. Indeed, while it's too early to signal the "all clear," it appears that banks will be able to slowly rebuild capital over the ensuing quarters and years.

- We expect market technicals to remain well balanced this year. Year-over-year gross supply in 2024 is expected to be flat, but net supply could be slightly lower due to increased maturities. Therefore, if rates stay elevated and credit quality persists, we should continue to see strong demand in 2024.

- While U.S. credit spreads may not be overly exciting from a historical perspective, yields in the sector recently reached the highest levels since the financial crisis. As a result, we believe IG should remain attractive to institutional investors and asset allocators.

- In terms of positioning, we continue to overweight banks, utilities, and the front-end (due

One of the biggest positives for U.S. IG corporates (besides the Fed) is the sector's historically elevated all-in yield. (%)

Yield to Worst

Source: PGIM Fixed Income and Bloomberg

to the latter's underperformance after spread curve flattening). We are more cautious on finance companies, specifically those with subprime exposure.

- Although the risks to our outlook are similar to those in other credit sectors, such as a revival in inflation, slower-than-expected economic growth or geopolitical flare ups, we would also point to the potential for increased M&A activity that results in weaker credit fundamentals.

- In **Europe**, the economy has held up well, but headwinds remain from economic sensitivity to energy prices (as well as their feed through to inflation), limited economic growth, still elevated (albeit falling) inflation, and the Russia/Ukraine war. A potential resolution to the latter could result in significant economic upside. Overall, risk of significant downside economic misses are more tail risk than base case.

- In terms of portfolio positioning, we are long risk and neutral spread duration in our European portfolios. In global mandates, we have a similar risk position with a minor underweight in spread duration. In addition, we have a moderate skew to more risk on the European side. From a sector perspective, we are long banks, energy, utilities, and underweight industrials denominated in U.S. dollars.

- Gross issuance is expected to remain manageable in 2024 and moderately higher than 2023, resulting in a slight increase in net supply.

GLOBAL LEVERAGED FINANCE

Outlook: Constructive on a total return basis, less so on an excess return basis. We don't believe the market is adequately pricing in economic headwinds, which could lead to lower core rates. Otherwise, technicals still appear supportive in the short term, and increased credit dispersion should lead to more alpha-generating opportunities.

■ While the U.S. economy remains far from a recession, we believe numerous headwinds are not adequately being priced into the U.S. high yield market. The lagged effects of tighter monetary policy, tighter lending standards, and the potential for fiscal tightening are headwinds to economic growth in 2024. Shrinking savings and slowing job growth will likely impact consumer confidence and spending. Should the consumer continue to pull back, downward pressures on corporate earnings and profit margins will increase.

■ The market's belief in an economic soft landing and the Fed's pivot has pushed high yield spreads to their tightest levels since April 2022, and the positive technical backdrop may push spreads even tighter until supply re-emerges in mid-January. Nonetheless, the upside of 25-50 bps of additional spread tightening is not enough to compensate for the risk of a still-existent downside scenario in 2024.

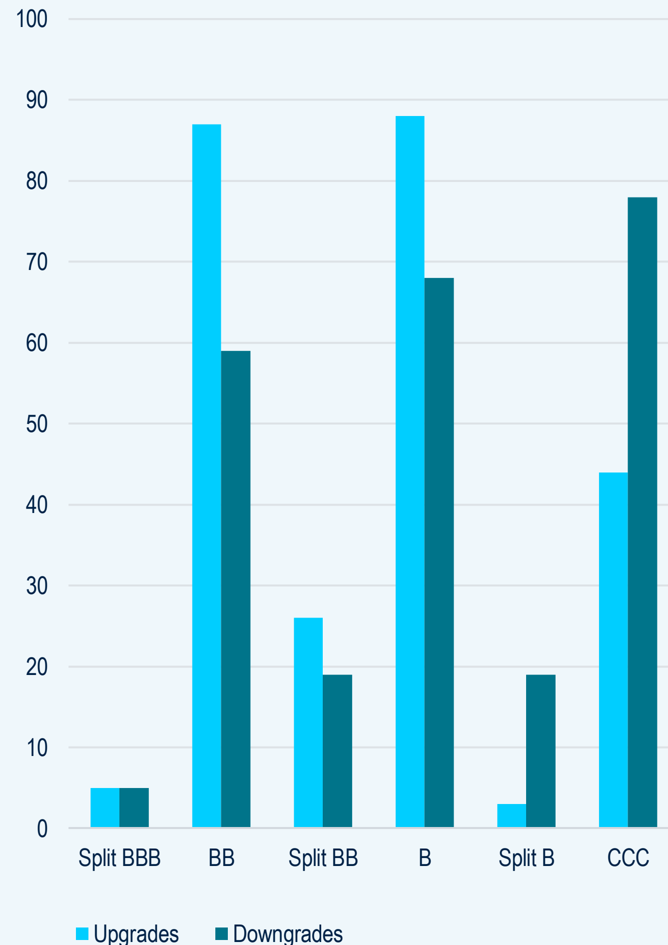
■ While high yield companies' earnings and liquidity generally remain strong and leverage remains well below the long-term average, credit metrics have shown some signs of deterioration, with revenues declining year-over-year for the second consecutive quarter and EBITDA margins slipping to a six-quarter low in Q3.

■ Due to the strength of most issuer's balance sheets, the absence of a significant maturity wall through 2024, and manageable (but higher) maturities in 2025, we don't anticipate a sharp increase in default rates. That said, the pace of credit ratings downgrades continues to increase, with downgrades of low single-B and CCC issuers exceeding upgrades by a wide margin in 2023. Should the economy follow our base case scenario, we expect default rates to remain manageable, rising to 5.0% over the next 12 months.

■ Meanwhile, the technical backdrop remains supportive due to a variety of factors, including lower new issuance, a sizeable group of rising stars, and a growing share of below-investment grade companies opting to issue in the private credit markets. This has led to a meaningful supply deficit and an overall shrinking of the high yield market, which has continued to support market technicals.

■ With positive technicals showing no signs of abating over the near term, our short-term outlook is neutral to modestly positive, and we are looking to take advantage of an expected

Upgrade-to-downgrade ratio by rating
(# of issuers in 2023)



Source: J.P. Morgan.

uptick in new issuance to opportunistically add higher-quality, short-duration issues in the secondary market. We are maintaining overweights to home construction as well as the electric and independent energy sector names, while maintaining underweights in technology, consumer cyclical services, media & entertainment, and wirelines.

- Following the strong returns of 2023, we expect U.S. leveraged loans to post total returns of 7.0%-7.5% in 2024, supported by high all-in current coupons and yields, decelerating outflows from bank loan mutual funds, modest net new supply, and a growing share of loans being refinanced in the private or high-yield market. Our return forecast includes an expected 1-2 point price depreciation either due to defaults and/or negative credit migration or continued repricing activity that leads to tighter spreads. As a result, there's upside risk to our forecast should the current market momentum continue for longer than expected and loan prices hold steady or rise further.

- Loan defaults rose and approached their long-term average in recent months amid rising corporate headwinds and higher interest rates. We expect the higher cost of capital to continue to pressure free cash flows in 2024—particularly for lower-quality, sponsor-owned companies with loan-only capital structures. Given that these types of issuers currently comprise a larger portion of the overall market than in prior cycles, we expect loan default rates (including distressed exchanges) to rise to 4-4.5% by year-end 2024 and cumulative defaults of 9-10% over the next 24 months.

- We continue to favor public, BB and high single-B loans over sponsor-owned, low single-B and CCC loans as we expect those lower-quality loans to be most impacted by the challenging fundamental backdrop. We believe that credit selection and deep, fundamental credit research/modeling is becoming increasingly important, and that the avoidance of defaults will be the biggest driver of alpha over the next 12–24 months.

- We remain constructive on the total return prospects for European High Yield and Loans, but more cautious on an excess return basis. Spreads tightened significantly in 2023 as the supply of new issuance remained modest and markets priced in a lower probability of recession. While we expect spreads to remain rangebound or tighten over the short term amid a general lack of supply, we think spreads are more at risk of widening as European economies continue to slow.

- An earnings recession and/or increased interest costs will erode fundamentals, and we expect to see a pickup in defaults over the next 12 months, but this should be relatively modest given the lack of near-term maturities, issuers' strong liquidity profiles, and the generally high credit quality within the market. Given this context, we are confident that total returns will remain positive for the asset class in 2024 in most scenarios, save for a very severe recession (we assign a low probability to a severe recession).

- In terms of positioning, we are running market neutral levels of risk with reduced levels of risk in cyclical sectors, lower conviction credits, and credits that are sensitive to higher interest costs. We are also opportunistically adding carefully selected credits that have dislocated from fair value and present compelling relative-value opportunities. Ultimately, we think active management and accurate credit selection will be rewarded amid increased credit dispersion.

EMERGING MARKET DEBT

Outlook: Several evolving dynamics should provide a tailwind for emerging markets in 2024. The carry from EM debt alone is enough to generate attractive returns, and our hard-currency credit barbell—with a mix of sovereigns and quasi-sovereigns—is well suited for the environment. We expect local markets to do well in early 2024 given the Fed's recent pivot and healthy trends of disinflation across most countries. We are neutral on the U.S. dollar with a relative-value focus in currencies.

The EM Landscape

■ After suffering for almost four years under successive shocks, we believe the headwinds from higher inflation and rates that weighed on emerging markets will dissipate in 2024. We start the year with a mixed outlook on economic growth, which we believe will remain positive, albeit slowing through 2024. Geopolitics remain a risk, with pressure points in Ukraine and Israel amidst the great power competition between the U.S. and China.

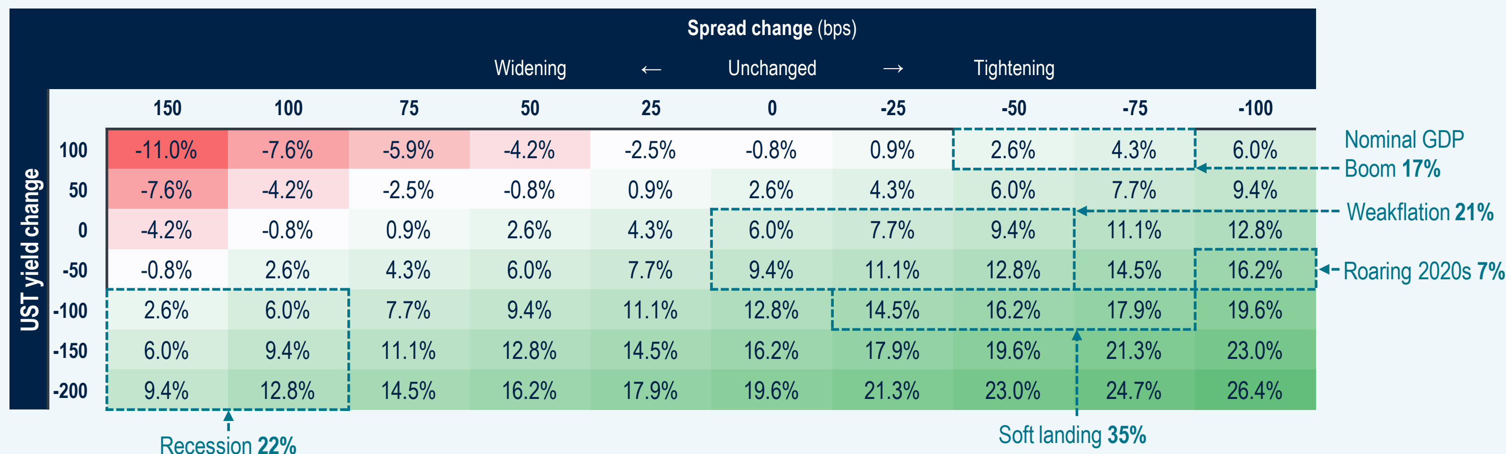
■ While spreads tightened meaningfully into 2023 year-end, we expect them to grind tighter given the backdrop of declining inflation, a likely pivot from the Fed, and mildly positive growth. Spreads remain wide to historical levels in some credit segments—as well as to other spread asset classes—and are contributing to elevated yields in the 8% area. The carry alone on EM hard currency is enough to generate attractive returns, but even mild spread tightening could raise total returns to double digits when coupled with declining yields in core DM bond markets.

■ Our expectation for spread tightening is based upon fundamental resilience and mean reversion as emerging markets continue to normalize from their multi-year shock. Fiscal deficits have narrowed in most countries and real rates remain elevated as central banks have held off on entering cutting cycles. As macro conditions evolve, we expect to see further fiscal improvement. Furthermore, with inflation in EMs easing faster than DMs, we see a rate cutting cycle benefitting EM growth as real rates remain positive. We anticipate the resiliency of EM economies will restore the important growth differential relative to DM economies.

EM Hard-Currency Government Bonds

■ We expect another strong year in EM markets and, outside of a serious contraction in growth, hard currency EM debt may generate high total returns and meaningful outperformance in 2024. Even in the event of a recession, the high carry and duration component of the asset class should be enough to

1-year Hard Currency expected return analysis



UST yield change \ Spread change (bps): Widening ← Unchanged → Tightening	150	100	75	50	25	0	-25	-50	-75	-100
100	-11.0%	-7.6%	-5.9%	-4.2%	-2.5%	-0.8%	0.9%	2.6%	4.3%	6.0%
50	-7.6%	-4.2%	-2.5%	-0.8%	0.9%	2.6%	4.3%	6.0%	7.7%	9.4%
0	-4.2%	-0.8%	0.9%	2.6%	4.3%	6.0%	7.7%	9.4%	11.1%	12.8%
-50	-0.8%	2.6%	4.3%	6.0%	7.7%	9.4%	11.1%	12.8%	14.5%	16.2%
-100	2.6%	6.0%	7.7%	9.4%	11.1%	12.8%	14.5%	16.2%	17.9%	19.6%
-150	6.0%	9.4%	11.1%	12.8%	14.5%	16.2%	17.9%	19.6%	21.3%	23.0%
-200	9.4%	12.8%	14.5%	16.2%	17.9%	19.6%	21.3%	23.0%	24.7%	26.4%

Source: PGIM Fixed Income

offset any potential spread widening for a still-meaningful positive total return. As DM rates retreat, foreign direct investment as well as portfolio and fund inflows into EM markets will likely support technicals, particularly given EM sovereigns' balanced net financing needs.

■ We believe that our barbell positioning remains the best approach given the current environment. At one end of the barbell, we continue to prefer a mix of BB and BBB sovereign and quasi-sovereign issuers, mainly in the belly of their respective curves. This exposure is supplemented with the elevated yields on the other, higher-beta end of the barbell, which consists of B and distressed issuers, mainly at the front of their respective curves. Despite overall neutral positioning in single-B issuers, we believe our selective approach within this group can contribute to meaningful returns going forward. Moreover, we have an overweight in the more distressed segment of sovereign issuers, where some issuer prices already reflect considerable downside. While there are clear incentives among multilateral and bilateral lenders to resolve situations of default and distress among EM sovereigns, we remain mindful of valuations and realistic about what the market has already priced in.

■ Longer term, a number of dynamics should provide a tailwind for emerging markets. These include the intense jockeying for power and influence in the global south by the U.S. and China, de-risking supply chains from China and increased foreign direct investment across other EMs, the growing need for commodities to fuel technology and green infrastructure, improved demographic trends, and an increased EM share of global GDP and trade.

EM Hard-Currency Corporate Bonds

■ Although the spread tightening in 2023 brought EM corporate spreads to their historical average, opportunities likely remain as they have significantly underperformed their developed market counterparts. EM corporate high yield spreads remain relatively elevated despite a 2023 spread return of nearly 6%. While spreads could compress further in a favorable macro environment, The yield on the EM corporate index of about 7.5% should contribute to an attractive total return in most scenarios considering most issuers' resilient fundamentals.

■ We believe the best value is in EM corporate BBs (spreads of ~380 bps) and BBBs (~230 bps), respectively. We expect EM corporate high yield defaults (excluding Russia and China) to remain within the historical range of 3-4% and inline with those of developed markets. The expected overall net financing for 2024 remains deeply negative, and early indications suggest investor flows may become more supportive. Risks include credit stress related to higher funding costs and/or economic slowdowns.

■ We continue to favor countries, such as India and Mexico, that are growing rapidly and benefitting from the trend of de-risking supply chains from China. We have covered some of our underweights in lower-rated, single-B issuers, but remain selective given refinancing challenges in cyclical sectors, such as chemicals.

EM Local-Currency Government Bonds

■ Following 2023's strong returns, we expect local markets to perform well in 2024 given the recent pivot by the Fed and healthy disinflation trends across most countries. While we are bullish on EM duration, the rally in Q4 2023 makes us somewhat cautious around entry levels. As a result, we are looking to reduce exposure and re-engage at better entry points. It will be challenging for spot yields to outperform forwards without support from stronger EM currencies and lower commodity prices.

■ We have a directional bias for long rates in Latin America and Asia versus underweights in the CEEMEA region. We are overweight Brazil, Mexico, and South Korea and underweight South Africa, Chile, and Hungary. With respect to our overweights, we believe Brazil could potentially cut its policy rate to less than 9% versus the 9.5% that is priced into the curve. In Mexico, we expect Banxico to begin cutting rates in Q1 of 2024. For South Korea, only 50 bps of rate cuts are currently priced into the market over the next two years versus the 175 bps of cuts that are priced for the U.S. Our underweight to South Africa is based on its deteriorating fiscal outlook and a general election in 2024 that is likely to limit any early easing by the SARB. Meanwhile, markets in Chile and Hungary are both priced for perfection with a terminal rate of 4.5% and 5.0%, respectively.

■ With respect to curve positioning—due to negative roll and carry considerations as well as

elevated issuance—we expect the belly of the EM swap curves (5- to 7-years) to outperform the front end and the long end. We maintain a steepening bias beyond the 7-year point.

EM Currencies

- We have turned neutral on the U.S. dollar with a relative-value focus to start 2024. If the dollar did not benefit from the higher-for-longer rates narrative in the U.S. and moribund growth in Europe and China in Q4 2023, we see low odds that it will benefit from a narrative now focused on rate cuts. Given the Fed pivot, we believe USD would only benefit if there is a hard economic landing and volatility picks up. We would need to see improvement in growth in Europe and cyclical improvement in China before turning more constructive on EMFX.

- Regionally, we are long Middle East and North Africa and Europe, neutral Latin America, and short Asia. In individual currencies, we favor long positioning in the South African rand (valuation), Indian rupee (carry), Indonesian rupiah (carry), Mexican peso (carry), and Turkish lira (carry and restored policy orthodoxy). We favor shorts in the Taiwan dollar (low carry), Philippine peso (current account deterioration and low carry), Hungarian forint (dovish central bank), and Peruvian sol (low carry). With aggressive Fed cuts priced in for 2024, we believe the outperformance in Asia seen during Q4 2023 is unlikely going forward.

MUNICIPAL BONDS

Outlook: Balanced with a positive lean, mainly for tax-exempt munis. We are constructive on a positive return scenario for the sector. The market has adjusted to the higher-rate environment and recently touched yields not seen in more than a decade. As a result, the value of the municipal bond tax exemption to a U.S. taxpayer has increased materially since the Fed commenced liftoff in March 2022.

- Most of our economic scenarios—namely a soft landing, modest growth, or weakflation – should support muni market fundamentals. It would likely take a prolonged recessionary environment for muni credits to experience downgrades and/or spread widening.

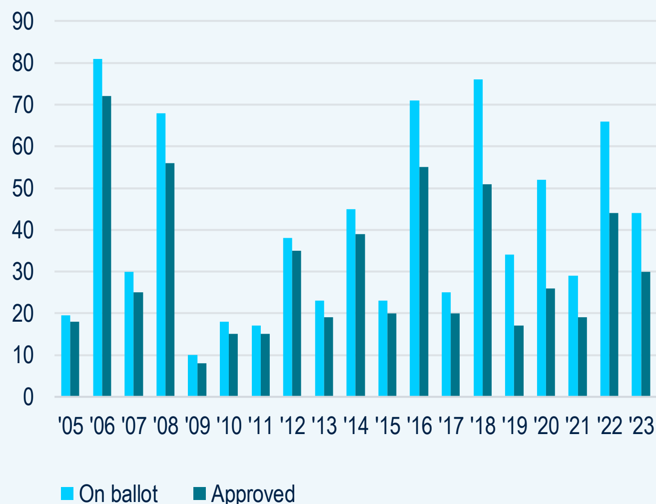
- The credit profiles of many state and local governments remain sound, anchored with near-record levels of reserves if budgetary issues arise (e.g., a slowing U.S. economy or exogenous shocks). States may be holding reserves in case of a recession or to build out capital projects instead of self-funding. These conditions should continue to support municipal bond returns 2024.

- This is a Presidential Election year. The fiscal backdrop has changed with the ongoing concerns over the federal deficit. Several provisions from President Trump's signature tax reform bill in 2017 will expire at the end of 2025, including all major individual income tax items. If cuts to the individual income taxes are not renewed, demand from individuals for municipal bonds could modestly increase. At the same time, the election cycle could introduce periodic bouts of volatility.

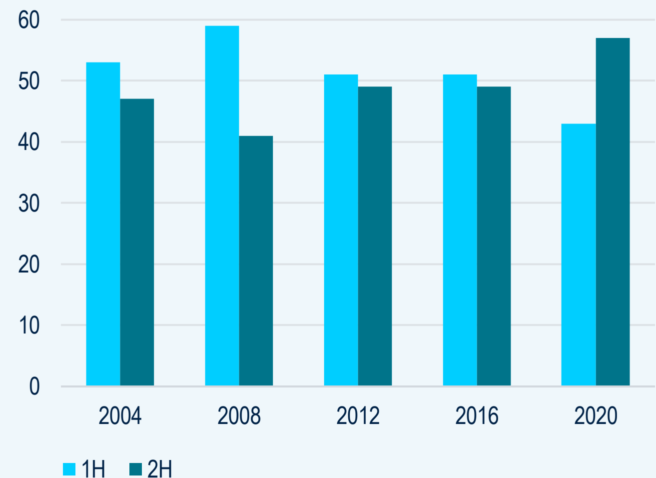
- In terms of technicals, supply is likely to pick up in 2024 driven by lower yields, deferred issuance from 2023, infrastructure projects, and ongoing capex needs. Street estimates average $400 billion for 2024 (a 10% increase over 2023) with manageable issuance from the states. While fund flows are hard to predict, they could be pivotal if they start to gain momentum. However, even with the very strong rally at the end of 2023, flows were sluggish. With that stated, the outflow cycle appears to be mainly behind us with $115 billion leaving the asset class over the last two years. The primary risk to this is an outsized move to higher interest rates, which could renew the pressure on the sector's flows.

- On taxable munis, we are modestly positive. We expect spreads to directionally follow IG corporate spreads. Taxable munis have lagged corporate spread tightening in Q4, leaving valuations looking fairly attractive compared to corporates. While there were supply constraints in 2023, there is potential for new deals to hit the market in January. Street estimates call for $45-50 billion in taxable supply this year.

Bonds on ballots ($ billion)



Issuance during presidential election years (%)



Source: Barclays Research, Bloomberg.

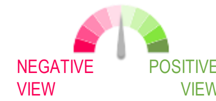
SECTION 5

SUMMARIES

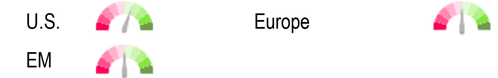
05

SUMMARY OF OUTLOOKS & ASSET CLASS VIEWS

This summary consists of our short- and long-term (1-yr) sector outlooks. The latter is based on a scale of 1-10 and indicates our expectation for the sector's excess return relative to its broader, regional fixed income market (which is assigned its own 1-10 market score in the box to the right). A sector score of 1 represents an expectation for it to vastly underperform the market, and 10 indicates an expectation for the sector to vastly outperform the market.[1]



Market Scores



Sector	Short-term Outlook	Long-term (1-yr) Outlook[1]	
DM Rates	Ample tactical opportunities amidst historically wide trading ranges. As the momentum behind the Q4 rally dissipates, U.S. rates may revert higher, while European and UK rates remain in a tighter relative range. Spring wage negotiations will be key for the BoJ and whether its policy rate moves out of negative territory.	U.S. Europe UK	Japan
Agency MBS	Cautious in the near term. Although we're cautious after Q4's sharp spread tightening, our long-term view of the sector and its potential excess returns remains positive. We continue to favor specified pools, while underweighting production coupons (30-years, 6% and higher). The convexity profile of recent production has deteriorated further with conforming loan limits rising again; those buyers may quickly refinance into lower mortgage rates.	Agency MBS	
Securitized Credit	Senior tranches remain attractive, selective on credit. We continue to favor senior tranches given their attractive risk-adjusted returns and robust structural credit protection, but believe spreads at the top of the capital structure will remain rangebound, making carry the dominant theme in 2024. Further down the capital stack, we are biased toward wider spreads as the recent rally—coupled with weakening fundamentals—could weigh on the most levered tranches. We remain patient and positioned in shorter spread duration assets at the top of the capital structure, while staying extremely selective and tactical on more credit-sensitive investments.	CMBS CLOs	ABS
Global IG Corporates	We expect U.S. investment grade corporate spreads to remain rangebound between 95-125 bps in 2024. Performance will likely be driven more by carry than by spread tightening. In this environment, credit selection takes on additional importance—i.e., alpha is likely to come from names not owned versus those that are. We believe attractive yields, as well as strong fundamentals and technicals, will support the sector going forward.	U.S. Corps. 1-10 U.S. Corps. 10+	European Corps. 1-5 European Corps. 5+
Global Leveraged Finance	Constructive on a total return basis, less so on an excess return basis. We don't believe the market is adequately pricing in economic headwinds, which could lead to lower core rates. Otherwise, technicals still appear supportive in the short term, and increased credit dispersion should lead to more alpha-generating opportunities.	U.S. High Yield 1-5 U.S. High Yield 5+ U.S. Leveraged Loans	Euro High Yield BB Euro High Yield B and below Euro Leveraged Loans
EM Debt	Several evolving dynamics should provide a tailwind for emerging markets in 2024. The carry from EM debt alone is enough to generate attractive returns, and our hard-currency credit barbell—with a mix of sovereigns and quasi-sovereigns—is well suited for the environment. We expect local markets to do well in early 2024 given the Fed's recent pivot and healthy trends of disinflation across most countries. We are neutral on the U.S. dollar with a relative-value focus in currencies.	Sov. Hard Currency IG Sov. Hard Currency HY Local rates[2]	EMFX[2] Corps. IG Corps. HY
Municipal Bonds	Balanced with a positive lean, mainly for tax-exempt munis. We are constructive on a positive return scenario for the sector. The market has adjusted to the higher-rate environment and recently touched yields not seen in more than a decade. As a result, the value of the municipal bond tax exemption to a U.S. taxpayer has increased materially since the Fed commenced liftoff in March 2022.	Taxable	

[1] The positioning in a respective portfolio may not be identical to the long-term ratings. The ratings and information herein is for comparison purposes.
[2] The scores on the indicated asset classes are on an absolute basis; i.e., the expectations for risk-adjusted market returns are embedded within the asset class specific returns.

Sector		Subsector	Spread change (bps) Q4	SOFR OAS 12/31/23
CMBS	CMBS: Conduit AAA	First-pay 10-year	-11	157
	CMBS: Conduit BBB-	BBB-	-44	917
	CMBS: SASB – Senior	AAA	0	200
	CMBS: SASB - Mezz	BBB-	0	440
	CMBS: Agency Multifamily	Senior	-6	96
Non-Agency RMBS	Legacy	RPL Senior	+14	173
	Legacy	'06/'07 Alt-A	-25	260
	GSE Risk-Sharing	M2	-40	210
CLOs	CLO 2.0	AAA	-2	163
	CLO 2.0	AA	+5	230
	CLO 2.0	BBB	+25	425
ABS	Unsecured Consumer Loan ABS	Seniors	+31	182
	Unsecured Consumer Loan ABS	Class B	+41	237
	Refi Private Student Loan	Seniors	+6	187
	Credit Card ABS	AAA	+18	82

Source: PGIM Fixed Income.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q4	YTD	Q4	YTD	12/31/23
U.S. Corps.	8.50	8.52	-22	-31	99
European Corps.	5.52	8.19	-16	-30	138

Source: Bloomberg. Represents data for the Bloomberg U.S. Corporate Bond Index and the Bloomberg European Corporate Bond Index (unhedged).

	Total return (%)		Spread / yield change (bps)		OAS (bps)/ yield %
	Q4	YTD	Q4	YTD	12/31/23
EM Hard Currency	9.16	11.09	-47	-68	384
EM Local (Hedged)	4.26	7.51	-1	-1	6.19
EMFX	5.28	8.44	0	2	8.93
EM Corps.	5.52	9.08	-17	-34	312

Source: J.P. Morgan.

	Total return (%)		Spread change (bps)		OAS/ DM (bps)
	Q4	YTD	Q4	YTD	12/31/23
U.S. High Yield	7.16	13.45	-71	-145	323
Euro High Yield	5.63	12.78	-49	-114	399
U.S. Leveraged Loans	2.85	13.04	-13	-114	538
Euro Leveraged Loans	1.68	13.53	-24	-165	545

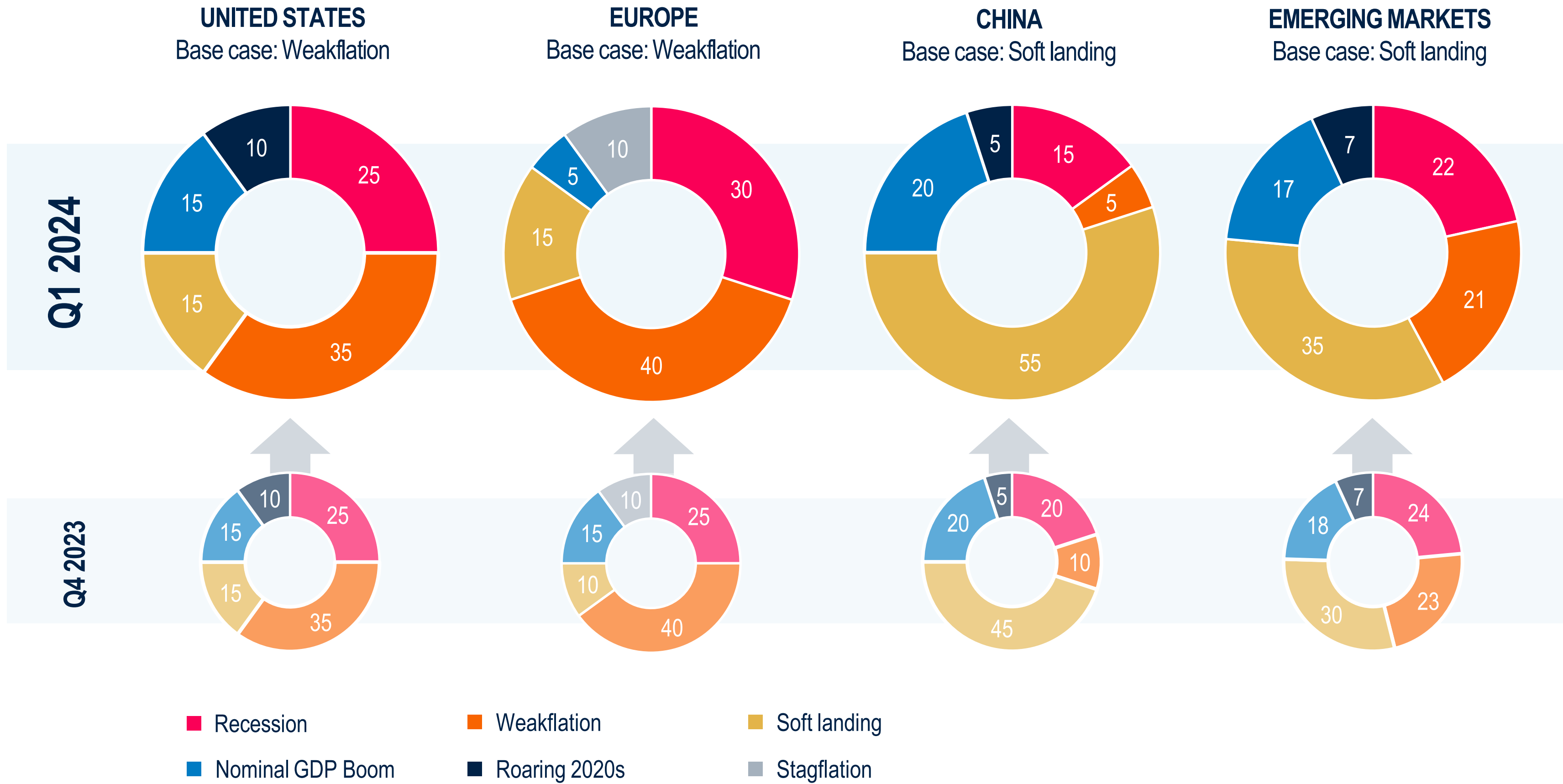
Source: ICE BofAML and Credit Suisse.

	Total return (%)	
	Q4	YTD
High Grade Tax-exempt	7.89	6.40
High Yield Tax-exempt	9.21	9.21
Long Taxable Munis Agg. Eligible	10.05	9.88

Source: Bloomberg. Represents the Bloomberg Municipal Bond Indices.

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures. All investments involve risk, including possible loss of capital. An investment cannot be made directly in an index. All data as of December 31, 2023.

FORECASTED ECONOMIC SCENARIOS BY REGION (%)



Source: PGIM Fixed Income forecasts. Note: Probabilities for emerging markets may not sum to 100% due to rounding. For emerging markets, we assume a 'global growth' scenario by taking a weighted average of the U.S., Europe, and China using the following weights: U.S. (40%), Europe (10%) and China (50%).

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of **January 2024**.

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INDEX DESCRIPTIONS

U.S. INVESTMENT GRADE CORPORATE BONDS

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EUROPEAN INVESTMENT GRADE CORPORATE BONDS

Bloomberg European Corporate Bond Index (unhedged): The Bloomberg Euro-Aggregate: Corporates bond Index is a rules-based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.

U.S. HIGH YIELD BONDS

ICE BofAML U.S. High Yield Index: The ICE BofAML U.S. High Yield Index covers US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, and at least one year remaining term to final maturity as of the rebalancing date.

EUROPEAN HIGH YIELD BONDS

ICE BofA European Currency High Yield Index: This data represents the ICE BofA Euro High Yield Index value, which tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P, and Fitch). Qualifying securities must have at least one year remaining term to maturity, a fixed coupon schedule, and a minimum amount outstanding of €100 M. ICE Data Indices, LLC, used with permission.

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U.S. SENIOR SECURED LOANS

Credit Suisse Leveraged Loan Index: The Credit Suisse Leveraged Loan Index is a representative, unmanaged index of tradable, U.S. dollar denominated floating rate senior secured loans and is designed to mirror the investable universe of the U.S. dollar denominated leveraged loan market. The Index return does not reflect the impact of principal repayments in the current month.

EUROPEAN SENIOR SECURED LOANS

Credit Suisse Western European Leveraged Loan Index: All Denominations EUR hedged. The Index is a representative, unmanaged index of tradable, floating rate senior secured loans designed to mirror the investable universe of the European leveraged loan market. The Index return does not reflect the impact of principal repayments in the current month.

EMERGING MARKETS U.S.D SOVEREIGN DEBT:

J.P. Morgan Emerging Markets Bond Index Global Diversified: The Emerging Markets Bond Index Global Diversified (EMBI Global) tracks total returns for U.S.D-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. To be deemed an emerging market by the EMBI Global Diversified Index, a country must be rated Baa1/BBB+ or below by Moody's/S&P rating agencies. Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2020, J.P. Morgan Chase & Co. All rights reserved.

EMERGING MARKETS LOCAL DEBT (UNHEDGED)

J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index: The Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM Global) tracks total returns for local currency bonds issued by emerging market governments.

EMERGING MARKETS CORPORATE BONDS

J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified: The CEMBI tracks total returns of U.S. dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries.

EMERGING MARKETS CURRENCIES

J.P. Morgan Emerging Local Markets Index Plus: The JP Morgan Emerging Local Markets Index Plus (JPM ELMI+) tracks total returns for local currency–denominated money market instruments.

MUNICIPAL BONDS

Bloomberg Municipal Bond Indices: The index covers the U.S.D-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. The bonds must be fixed-rate or step ups, have a dated date after Dec. 13, 1990, and must be at least 1 year from their maturity date. Non-credit enhanced bonds (municipal debt without a guarantee) must be rated investment grade (Baa3/BBB-/BBB- or better) by the middle rating of Moody's, S&P, and Fitch.

U.S. TREASURY BONDS

Bloomberg U.S. Treasury Bond Index: The Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index.

MORTGAGE BACKED SECURITIES

Bloomberg U.S. MBS—Agency Fixed Rate Index: The Bloomberg U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage.

COMMERCIAL MORTGAGE-BACKED SECURITIES

Bloomberg CMBS: ERISA Eligible Index: The index measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974, which will deem ERISA eligible the certificates with the first priority of principal repayment, as long as certain conditions are met, including the requirement that the certificates be rated in one of the three highest rating categories by Fitch, Inc., Moody's Investors Services or Standard & Poor's.

U.S. AGGREGATE BOND INDEX

Bloomberg U.S. Aggregate Bond Index: The Bloomberg U.S. Aggregate Index covers the U.S.D-denominated, investment-grade, fixed-rate or step up, taxable bond market of SEC-registered securities and includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors. Securities included in the index must have at least 1 year until final maturity and be rated investment-grade (Baa3/ BBB-/BBB-) or better using the middle rating of Moody's, S&P, and Fitch.

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