PGIM FIXED INCOME

Q3 24 QUARTERLY OUTLOOK

Published July 2024

WHATS INSIDE?

Select a section to jump ahead.

	Total Returns (%)				
Individual FI Sectors	Q2 '24	YTD '24	2023	2022	2021
European Leveraged Loans	2.39	4.98	13.53	-3.36	4.87
U.S. Leveraged Loans	1.86	4.44	13.04	-1.06	5.40
European IG Corporate	1.49	3.85	8.19	-13.65	-0.97
European High Yield Bonds	1.39	3.23	12.78	-11.13	3.32
U.S. High Yield Bonds	1.09	2.58	13.45	-11.19	5.36
CMBS	0.67	1.53	5.42	-10.91	-0.64
EM Local (Hedged)	0.54	0.74	7.60	-8.85	-5.52
EM Debt Hard Currency	0.30	2.34	11.09	-17.78	-1.80
U.S. Treasuries	0.10	-0.86	4.05	-12.46	-2.32
Mortgage-Backed (Agency)	0.07	-0.98	5.05	-11.81	-1.04
Municipal Bonds	-0.02	-0.40	6.40	-8.53	1.52
U.S. IG Corporate Bonds	-0.09	-0.49	8.52	-15.76	-1.04
EM Currencies	-0.27	-1.38	8.44	-7.14	-3.09
U.S. Long IG Corporates	-1.74	-3.39	10.93	-25.62	-4.65
Long U.S. Treasuries	-1.81	-5.01	3.06	-29.26	-1.13
Multi-Sector					
Global Agg. Hedged	0.12	0.13	7.15	-11.22	-0.15
U.S. Aggregate	0.07	-0.71	5.53	-13.01	-1.39
Euro Aggregate (Unhedged)	-0.88	-1.21	7.19	-17.18	-4.71
Global Agg. (Unhedged)	-1.12	-3.16	5.72	-16.25	-1.54
Yen Aggregate	-2.77	-3.14	0.51	-5.30	-2.85
Other Sectors					
S&P 500 Index	4.28	15.23	26.29	-18.11	28.71
SOFR	1.35	2.72	5.18	1.66	0.03
U.S. Dollar (DXY Index)	1.26	4.47	-2.11	8.21	6.37

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 June 30, 2024. An investment cannot be made directly in an index.

SECTION 1

KEY CONVICTIONS & INVESTMENT THEMES

01

KEY CONVICTIONS & INVESTMENT THEMES

1 **Of Political Upheaval and Rising Deficits...**This year's global political developments not only add to future geopolitical uncertainty, but they also threaten to increase the fiscal risks already prevalent in the post-COVID environment. And elevated interest rates only aggravate the fiscal arithmetic. As a result, sovereigns yield curves for countries with high debt burdens and large deficits—such as the U.S., Japan, Italy, and France—may be intermittently subject to upward pressure on long rates.

2 **…the Mode of Moderation…**One aspect of the global economy's emergence from the post-COVID boil is the return of some "traditional" market constructs—inflation that is approaching targets, interest rates that are sitting near more historically normal levels, and newfound room for central banks to ease policy. The forces behind these constructs bolster our "moderation" base case for the global economy over the coming 12 months.

3 **…Yield Stability and the Strategic Case for Bonds…**Our ongoing expectation for range bound rates may feel pedestrian, but it's a key component of the strategic, asset-allocation case for bonds. Indeed, the relative-value shift over the last few years—i.e., the cheapening of bonds vs. stocks—has typically positioned bonds for compelling risk-adjusted returns. Furthermore, if stocks experience a sharp correction while the Fed is on hold or cutting rates, bonds historically act as solid portfolio shock absorbers.

4 **…and a High-Quality, Opportunistic Emphasis.** At this stage in the credit cycle, more frequent event risks, consumers' increasing focus on essentials, and moderating credit metrics (along with increased distressed exchanges), point our allocations towards high-quality securities. That said, we're seeking to add risk in situations where dislocations may mean revert and/or where sector dispersion reveals relative-value opportunities.

PGIM FIXED INCOME

SECTION 2

BOND MARKET OUTLOOK

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

02

Markets' Consolidation Belies Fiscal Concerns

This year has been a roller-coaster for the bond market as alternating waves of pessimism and optimism mirrored the wide swings in economic data. As doubts about the economic trajectory swirled—especially the inflation outlook—so went interest rates: up early in the year along with the inflation readings, then following inflation lower as the first half progressed.

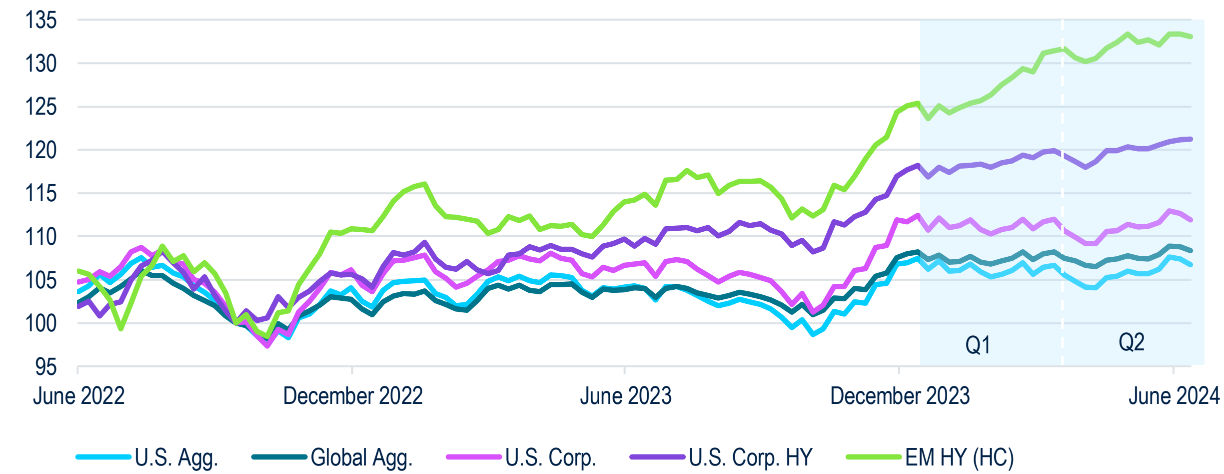
With little net change in yields, returns on high-quality fixed income paused in the first half. However, higher yielding sectors, such as high yield corporates and hard currency emerging markets debt, continued to post positive returns, albeit at a slower pace than in 2023 (Fig. 1).

An environment of high and stable long-term rates supports the bull case for fixed income.

For those seeking a quick drop in yields, this will be a disappointing market. Even with the likelihood of rate cuts, long-term yields should remain centered around current levels as: 1. a fair amount of rate cuts are already priced in; and 2. loose fiscal policy—and its resulting heavy government bond issuance—may impede any substantial, sustained decline in long rates. On net, this will likely result in a slow normalization (i.e., dis-inversion) of the yield curve with the

Figure 1

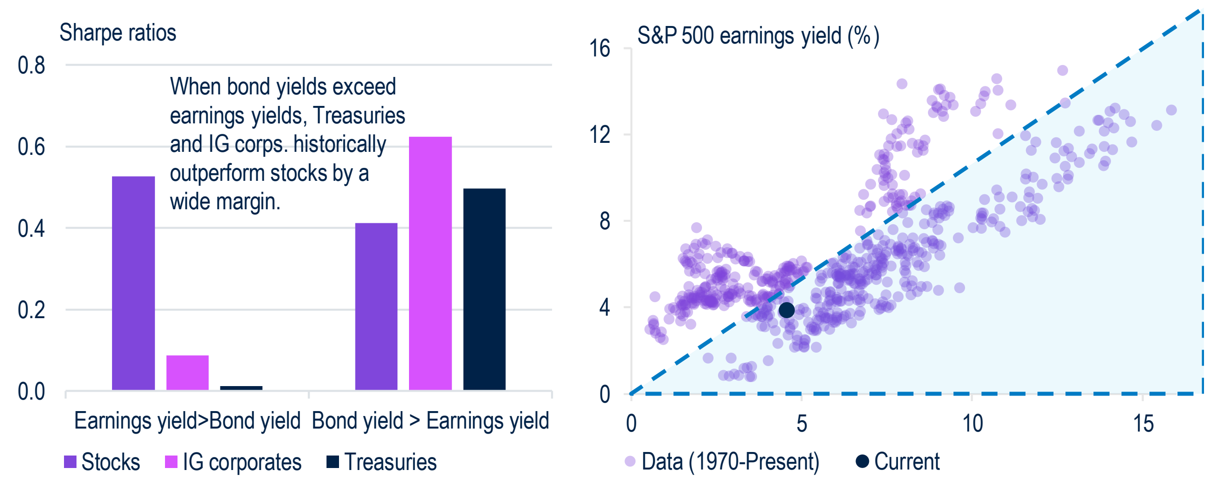
The "High Plains Drifter" Stealth Bull Market Continues (total return %)



Source: Bloomberg

Figure 2

Fixed income risk-adjusted returns have historically been favorable when bond yields are higher than equity earnings yields.



PGIM Fixed Income, Bloomberg, Haver Analytics outcome being little change in the range for long rates, despite any drop in short rates (see the following box on fiscal considerations).

The Appeal is in its Strategic Value

Granted, a range bound rate backdrop may seem like an uninteresting opening volley for a "bullish thesis for bonds." But this stability provides context to a few strategic points as events unfold in the second half of the year and beyond. First, the value of bonds from an asset allocation perspective—highlighted in "The Case for Rebalancing into Bonds, in Pictures"—is not to be underestimated given the shifts in valuations and the current point in the economic cycle. For example, if history is any guide, the shift in relative value over the last few years—particularly the cheapening of bonds versus stocks—has typically positioned bonds for competitive risk-adjusted returns (Fig. 2).

Second, the defensive characteristics of bonds at this point in the cycle are striking. If stocks experience a sharp correction while the Fed is on hold or cutting rates, bonds historically perform as solid shock absorbers in investors' portfolios (Fig. 3).

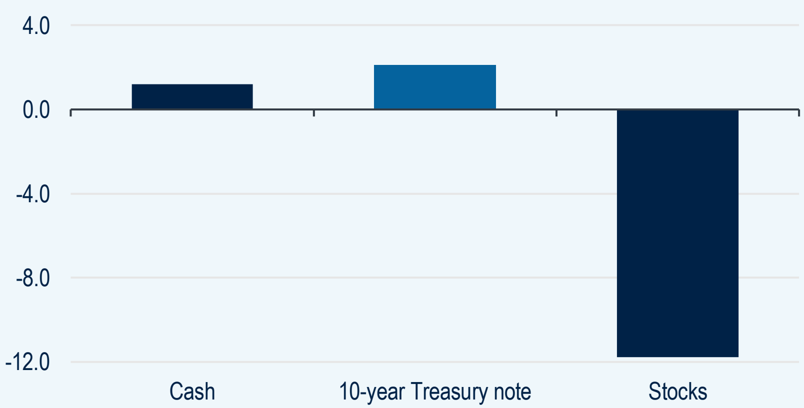
Our guardedly positive, long-term view for the credit sectors is another positive for market returns: the outlook for positive excess returns from credit—albeit at a less fevered pitch given the level of spreads—remains favorable thanks to positive fundamentals, issuer restraint, and a benign technical backdrop as investors move into fixed income to lock in higher returns at the peak of the interest-rate cycle.

Hazy Summer

As positive as we are about the long-term outlook for bonds—as well as the opportunity to add value in these volatile times—the short term is a much tougher call. Although we expect relatively stable rates over the long term, the summer is notorious for lower liquidity and outsized reactions to shocks, of which any number are possible: Eurozone or U.S. debt concerns and/or rising geopolitical risks in the Mideast, South China Sea, or even in the Western hemisphere as Russia increases its military presence. We'll remain on the lookout for both risks and opportunities as the season progresses—starting with France (see the following box).

Figure 3

Cash vs. Bonds during quarters when equities declined by at least 5% (1962-Present)



Returns based on Fed regime (%)

	Hiking	Hold	Cutting
Cash (%)	1.3	0.7	1.5
Bonds (%)	-1.2	4.6	4.0
Stocks (%)	-7.9	-12.5	-14.9
# of episodes	15	10	14

Source: PGIM Fixed Income and Haver Analytics

SPOTLIGHT: FRANCE'S FISCAL LITMUS TEST

While it's too early to speculate on the degree of fiscal loosening that may follow the U.S. elections, recent events in France gave us a glimpse of when political upheaval threatens to loosen already loose fiscal policy.

While European credit spreads have widened since the call for snap elections, the widening in French sovereign and quasi-governmental credit spreads were the most significant proportionally, more so than Italian debt or European corporate spreads more broadly (Fig. 4). As the trajectory of the politics and policy wavers over the coming weeks, the potential for investor anxiety and market volatility in the European credit markets will be impossible to handicap. Nonetheless, longer term, we are guardedly optimistic that spreads on corporate and sovereign issuers, such as Italy and France, will not spiral out of control and will instead end up around current levels or tighter. Why?

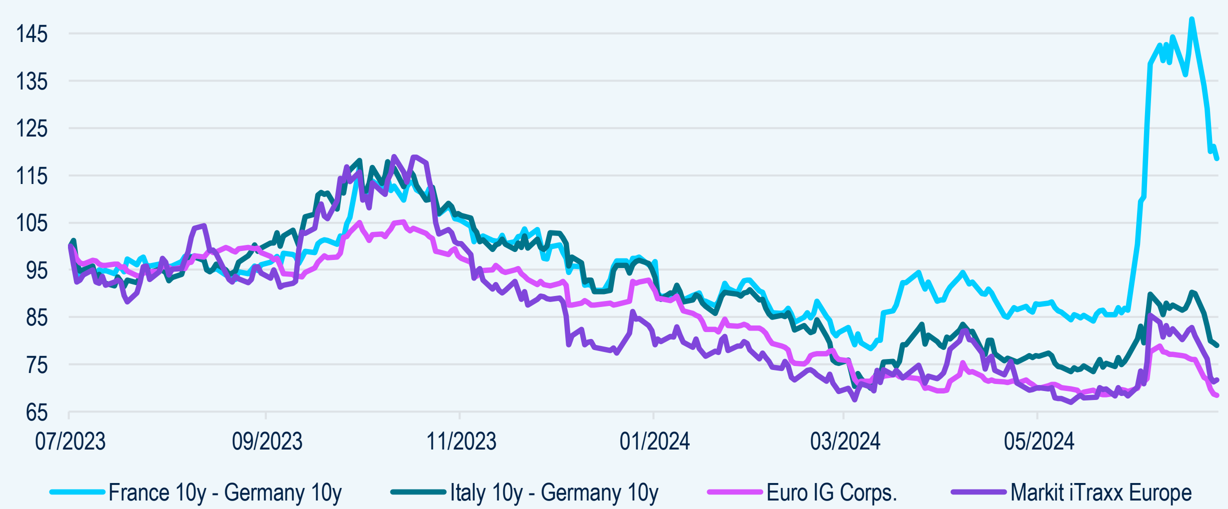
First, in contrast to the pre-2012 world, the Eurozone now has the collective political leverage and self-interest to enforce its fiscal rules on member countries. Furthermore, the ECB has developed the tools—such as the Transmission Protection Instrument—to stem market jitters in the bond markets caused by "unwarranted" external developments.

In order to qualify for ECB purchases under the TPI, the French government needs to take but modest steps in terms of fiscal tightening—0.5% of GDP per year in structural terms for a seven-year adjustment plan, or about 1% of GDP per year in the case of a four-year adjustment plan. Of course, this flies in the face of the policies being pitched, all of which risk pushing the budget deficit wider. However, the more unsettled the markets become, the more pressure it will apply on politicians to make the required budget adjustments and political overtures necessary for activating the TPI.

Furthermore, the ECB is seeking to keep monetary policy stable or somewhat easier. Therefore, any substantial increase in French and / or peripheral yields would interfere with transmission of the intended monetary policy and could theoretically be countered by ECB purchases under the TPI.

Yet, France can not qualify for the TPI until a government is formed, an adjustment program in compliance with the EC's guidance is agreed upon, and the government sufficiently demonstrates that the adjustment program is underway. Under normal conditions, it could take France well over six months to comply for TPI eligibility. However, an exigent and unwarranted increase in yields could galvanize politicians to decisively take the required steps to accelerate the timeframe to get France into the TPI implementation stage.

Figure 4
The main impact of France's snap elections materialized in French governments, which, on a proportionate basis, widened much more than Italian governments as well as European investment grade and high yield corporates (indexed to 100).



Source: Bloomberg

Bottom Line: When looking through quarter-to-quarter fluctuations, the strategic case for bonds remains strong. In our base case, the stealth bull market continues—one not generated by a drop in rates, but simply by the accumulation of yield itself. Meanwhile, we continue to see opportunities to add value in a volatile market. And, from an asset allocation perspective, the case for bonds is solid given their current relative valuations as well as their potential to act as a shock absorbers at this point in the market cycle.

We also delineate between our short-term and long-term views. Indeed, political, economic, and geopolitical risks continue to obscure the short-term outlook, perhaps portending an anxious summer. Longer term, the outlook for fixed income as an asset class looks strong on an absolute and relative basis with ample opportunities to add value through sector rotation and issue selection in volatile markets.

SPOTLIGHT: LOOSE FISCAL POLICY AND RISING GOVERNMENT INDEBTEDNESS: AN INTERMITTENT SHORT-TERM MARKET DRIVER WITH PERNICIOUS LONG-TERM EFFECTS.

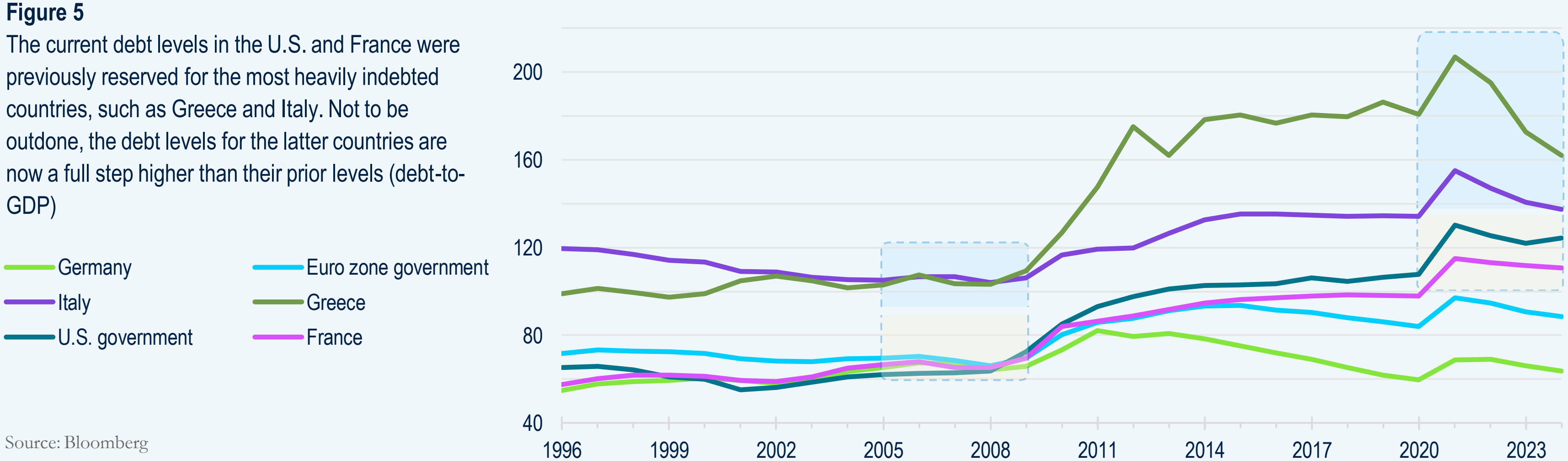
Every once in a while—but lately with increasing frequency as observed in 2022 when a UK budget proposal sent the Gilt market into a tailspin—investors' attention turns to loose fiscal policy and rising levels of indebtedness.

When investors are optimistic about disinflation and rate cuts, they don't seem to worry about debt burdens, deficits, and government bond issuance. But the fact of the matter is that debt burdens for countries like the U.S. and France are adding up as bouts of stimulus for crises, such as the GFC and COVID, get piled on top of what are already perennially high deficits.

The net result: the debt burdens of the U.S. and France are up at the same concerning levels occupied by Italy and Greece in 2006. Meanwhile, Italian and Greek debt levels have surged a full realm higher (Fig. 5). In other words, the 90%+ highly indebted zone has gone from a rarity among DM countries to more of a norm. The impact of these higher debt burdens is twofold. One, it leaves markets vulnerable to bouts of volatility, with the French snap election of recent weeks providing a striking example of a yield surge triggered by fiscal concerns.

Figure 5

The current debt levels in the U.S. and France were previously reserved for the most heavily indebted countries, such as Greece and Italy. Not to be outdone, the debt levels for the latter countries are now a full step higher than their prior levels (debt-to-GDP)



Source: Bloomberg

Second, and perhaps more important, is the fact that higher debt burdens lead to a chronic increase in the average, long-term cost of a government's debt service. Last August's U.S. Treasury refunding announcement of a surprisingly large issuance schedule delivered both a boost in market volatility and a significant and rapid rise in Treasury yields from sub 4% to nearly 5% by the end of September.

The long-term increase in debt-service costs resulting from heavy issuance can be seen in the progression of higher government yields relative to supply-neutral benchmarks, such as swap rates—i.e., the swap spread.

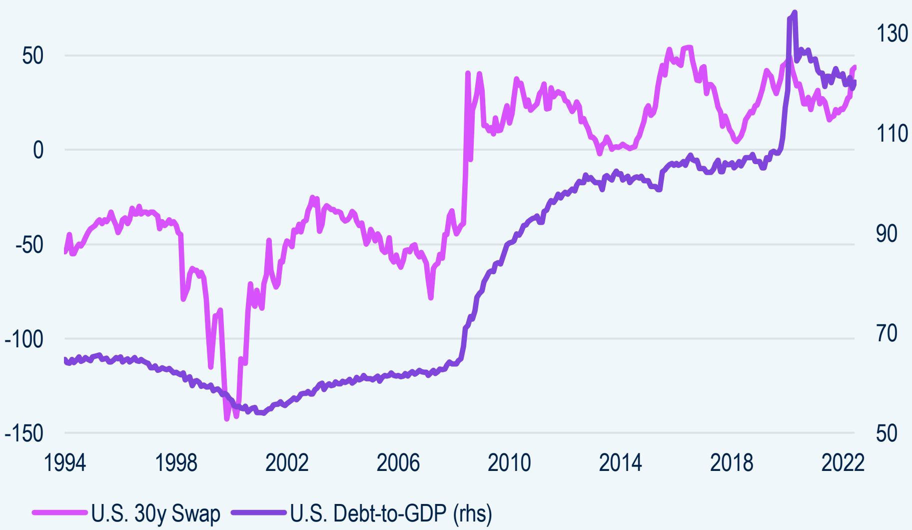
Over the last few decades, Treasury yields have risen relative to swaps along with the increase in the government's level of indebtedness. In contrast to the turn of the century, when Treasury yields were nearly 1.5% *lower* than swap yields at the 30-year point of the curve, at present, the yield on US Treasuries is roughly 0.75% *higher* than the corresponding yield on swaps (Fig. 6). In other words, as the government swung from a situation of surplus and paying down the debt to one of yawning deficits and a strikingly high debt-to-GDP ratio, the Treasury's cost of issuance has risen by roughly 2% relative to a supply neutral benchmark.[1]

Government indebtedness can cut both ways in the Eurozone. For example, thanks to Germany's relatively low debt levels, the country's bunds trade at *lower* yields than swaps. Meanwhile, heavily-indebted credits, such as France and Italy—analogous to the U.S.—have to pay yields above swap rates due to their higher levels of indebtedness (Fig. 7).

Our parting takeaway is that government indebtedness is increasingly becoming a market driver in the post-COVID environment. Government yields versus swaps will continue to be profoundly impacted by debt trajectories, creating both risks and opportunities for credit investors.

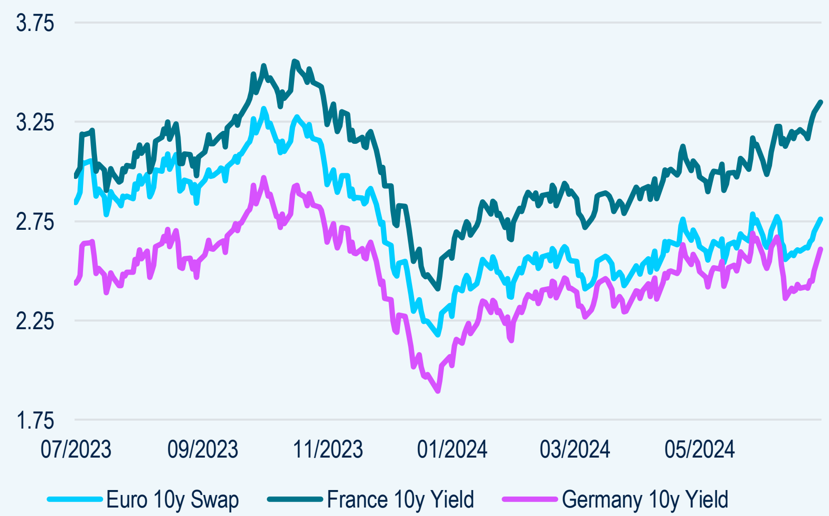
[1] Around ¼% of the shift in yields is the result of shifting the swap spread calculation from LIBOR to SOFR.

Figure 6
U.S. swap spreads tend to widen in periods when the deficit deepens, necessitating increased Treasury issuance (lhs, bps; rhs, ratio).



Source: Bloomberg

Figure 7
German bund yields continue to trade inside of swaps, while France continues to trade wide (%).



Source: Bloomberg

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BLOG POST

THE CASE FOR REBALANCING INTO BONDS, IN PICTURES

With yields up at levels not seen in more than a decade, bonds are definitely catching the eye of investors. In the current market environment, we see a compelling case for rebalancing into bonds vs. both stock and cash.

PODCAST

THE BUSINESS OF BONDS WITH PGIM FIXED INCOME'S CO-CIO

Bonds are back and with fixed income gaining interest with investors, we're taking an introspective look at our investment process and how we're navigating current market dynamics here at PGIM Fixed Income.

WHITE PAPER

FIVE OVER FIVE-THE STRUCTURAL SHIFTS TAKING PLACE IN EM

Prior to the onset of COVID-19, much had been written about the appeal of emerging market debt (EMD), touting the yield advantage as well as its lower correlation to other fixed income asset classes.

PGIM FIXED INCOME

SECTION 3

GLOBAL MACROECONOMIC OUTLOOK

By the Global Macroeconomic Research Team

03

Resiliency on the Surface, Crosscurrents Beneath

If investors were asked to describe the global economy in the first half of 2024, many might refer to its continued resiliency, particularly amidst the elevated tail risks that have accompanied the post-COVID expansion. Although these risks may be disconcerting at times, they have yet to derail steady global economic growth.

Indeed, our "moderation" base cases in the U.S., Europe, China, and the emerging markets over the coming 12 months are similar in their expectations for continued growth, supported by presumptive central bank rate cuts and general acceptance of ongoing fiscal largesse. Meanwhile, the crosscurrents of political upheaval, renewed signs of debt sustainability concerns, China's uncertain path forward, and ongoing geopolitical strife swirl below the surface, leading to a second half that could waver between periods of volatility in either direction, but without the weight or durability to derail the established expansion.

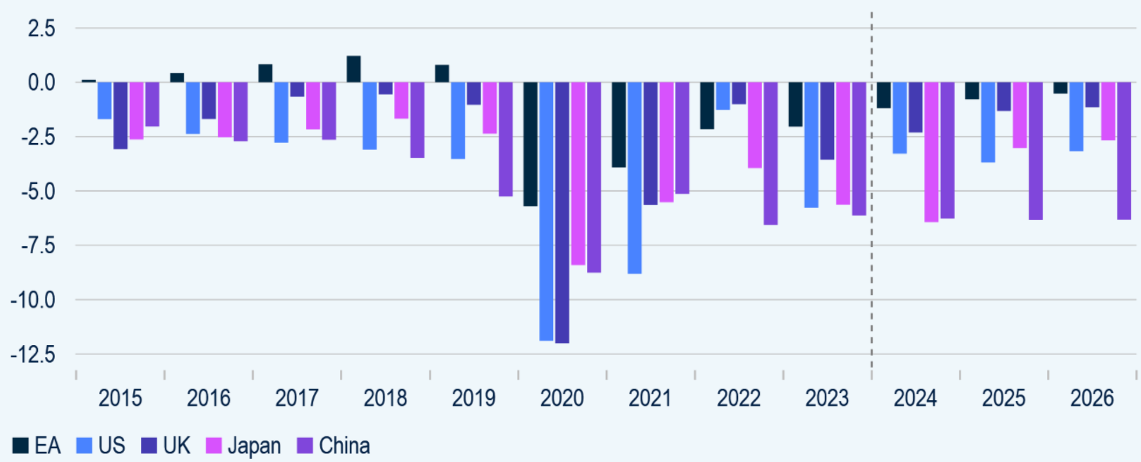
All Politics is Local, Ramifications can be Global

Europe's political shift—with far-right parties gaining momentum in recent parliamentary elections in core countries relative to the periphery—carries two broad implications: first, the EU's improved cohesion since COVID indicates that advocating for reforms will likely come from within, as opposed to pushing for change by threatening to exit the bloc.

Second, while the results have country-specific ramifications, e.g., potential calls for Flemmish independence in Belgium, the results not only sparked the country's snap elections, but they also showed how quickly and unexpectedly debt-sustainability concerns can resurface (see the DM rates section for more on the reaction of European rates).

Similarities surfaced globally in the first half of 2024. For example, Mexico's new Sheinbaum administration may seek constitutional reforms that could materially deepen its deficit and/or affect its business climate. Hence, it's possible that debt sustainability concerns won't be isolated to a specific region or country given the broad increase in global debt levels (Fig. 1), underscoring the need for country-specific analysis on topics ranging from immigration to monetary policy.

Figure 1
Global budget deficits set to extend well beyond the COVID years (government primary balances, % of GDP)



Source: Macrobond

At this point, the campaigning leading up to the U.S. elections in November is creating more questions than answers considering the first uneven presidential debate, the party conventions set for later this summer, and the forthcoming policy analysis. A couple top-of-mind questions that we're weighing include whether geopolitical conditions become more fraught leading up to an inauguration and how the next administration might approach situations in Europe and the Middle East.

A Dual-Sustainability Front

The concern that accompanied the announcement of snap elections in France was reminiscent of the UK's mini-budget debacle in 2022, and attention could turn to Italy this Autumn amidst a convergence of events that could test the market appetite for Italian sovereign debt. That said, Europe is managing its latest uncertainty with an expanded set of tools relative to those at its disposal during earlier, volatile periods (e.g., Greece in 2015).

Several European countries, including France, Italy, and Belgium, within the European Commission's Excessive Deficit Procedure (EDP) may benefit from a greater emphasis on flexibility over austerity in terms of returning deficits to the prescribed 3% threshold over the near term. The ECB's Transmission Protection Instrument is another tool—albeit an untested one with vague details—that could be beneficial as it can be used in scenarios where a country's yields climb due to events out of its control (see the preceding Market Outlook section for more on these tools).

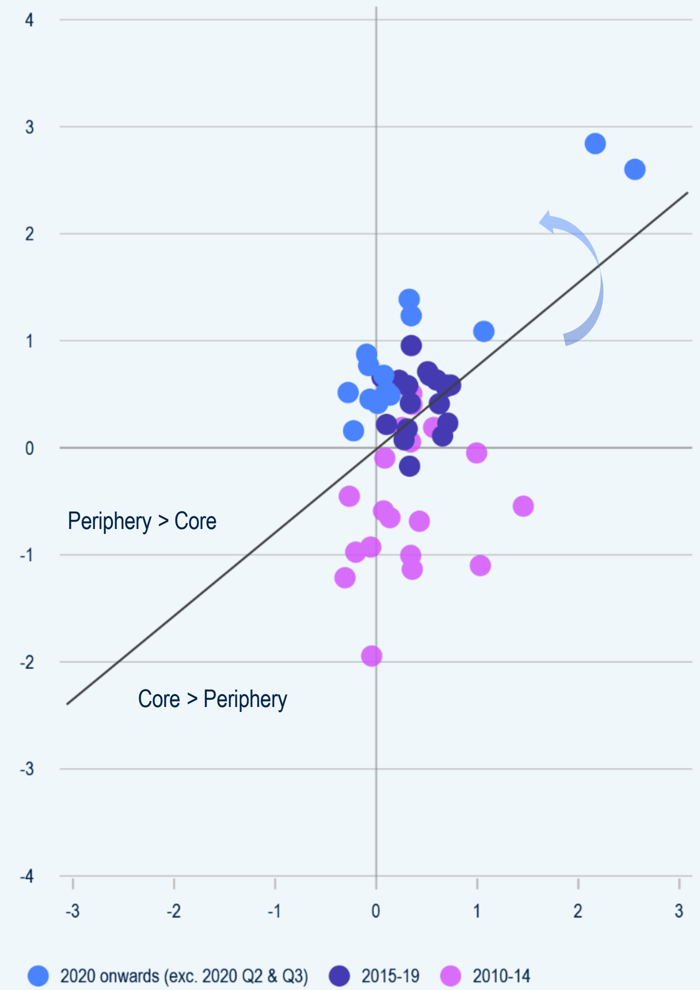
The list of countries joining the EDP is also telling. With Italy as an exception and in contrast to pre-COVID conditions, economic growth in the periphery, e.g., Spain and Greece, is now outperforming the core, e.g., France and Germany (Fig. 2). Sovereign yields tell a similar story with Greek 10-year yields below those from Italy and Portuguese 10-year yields below those from Spain.

The other aspect of sustainability pertains to the United States' economic outperformance, which has been partially driven by a significant fiscal impulse. Hence, the U.S. fiscal picture also continues to deteriorate, yet is meeting little resistance from either political party or presidential candidate, raising questions of whether it might eventually meet some market resistance. The sustainability of the U.S. expansion relative to other DM economies could also face pressure if immigration—which added significant numbers to the labor force in recent years—is affected going forward.

Precedent for Policy Divergence

Our introductory reference to resiliency also pertains to inflation. Following a sharp decline over 2023, European headline inflation looks to have stalled just above target since the start of the year. That said, near-term inflation trends and weak domestic demand provide additional confidence in the likely rate cuts to come.

Figure 2
Performance flip as peripheral GDP growth pulls ahead of Europe's core (core vs. periphery quarterly GDP growth, %)



Source: Macrobond

The ECB kept its options open regarding the timing of future policy decisions following its June rate cut—putting it ahead of the Fed's easing cycle—and we continue to expect two more cuts in 2024, bringing the policy rate down to 3.25% by year end. Ceteris paribus, we expect future ECB rate cuts will be shallower and will end at a higher terminal rate than prior easing cycles.

With UK inflation expected to pick up slightly through the remainder of the year, the BoE's decision to hold its policy rate at 5.25% in June was described as "finely balanced." Ultimately, three more policy committee members need to vote for a cut in August for the BoE to begin its easing cycle, adding emphasis to members' comments leading up to the next meeting. And Labour's general election victories resulted in limited movement across the Gilts complex thus far.

While base effects may keep U.S. inflation in the area of 2.5% in the months ahead, the Fed may go to notable lengths to explain why that dynamic shouldn't prevent it from cutting rates. Hence, we expect at least one 25 bps cut in 2024 with mid-December appearing as the most likely meeting for that decision. That said, following the more moderate June payroll report, we think the Fed could signal its rate cutting intentions relatively soon and potentially implement another cut in the second half of 2024 if given the opportunity. If the Fed is hindered from cutting rates this year, it could shift those cuts into 2025, and we see a total of 150 bps in Fed rate cuts through next year, which is one more than the Fed's guidance in June.

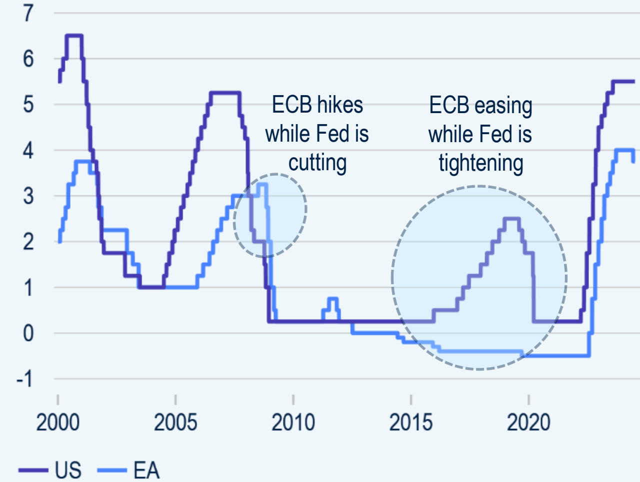
The implications of the ECB and BoE easing policy ahead of the Federal Reserve has generated some concerns about the effects of policy divergence. However, given the recent historical precedence, this particular separation appears manageable for now. Yet, policy divergence may continue to weigh on the Bank of Japan and the yen, which has experienced consistent pressure since the BoJ's rate hike that lifted its policy rate out of negative territory (Fig 3). Although the BoJ was expected to pursue a gradual pace to policy tightening, the pressure on the currency—as well as the risks of an inflation pass through—may prompt a more rapid approach with the potential for multiple rate hikes per year and quantitative tightening that could start in the second half of 2024.

China's Path Unlikely to Propel the Global Economy

Those awaiting an economic revival in China that is strong enough to assume leadership in global economic growth may have a longer wait in store. Authorities in China have taken a gradual stimulus approach following the country's real estate correction, cognizant that swift, sizable action could promote CNY depreciation as well as overcapacity issues.

Figure 3

Despite historical precedence for policy divergence (central bank policy rates, %)…



..it can still place pressure on certain markets, such as JPY/USD

Source: Macrobond

However, the gradual pace of stimulus could continue, particularly in light of China's recent and rare, long-term Treasury bond offering with an acceleration in local bond offerings targeted at maintaining "the necessary intensity of fiscal expenditure."

Moderation is the Mode

Despite China's gradual stimulus, our base case of "moderation" for the world's second largest economy remains the highest of the major regions at 75%, up from 70% to start Q2. The government's steady support for the real estate sector should reduce its drag on growth, with sentiment slowly recovering. Authorities will also continue to manage the currency to prevent excessive weakness and volatility. Nevertheless, risks are biased to the downside given the multiple policy challenges and constraints as well as a historically slow exit from slowdowns caused by balance-sheet challenges.

Our base case for the Euro Area shifts from "weakflation" to moderation with a 40% probability, up from 25% in Q2. The 15 percentage point increase came at the cost of our weakflation, stagflation, and recession scenarios. Our base case sees economic momentum building towards potential, supported by falling inflation and rising real incomes. Lower energy prices should also provide a boost to household spending.

In the U.S., our base case also changed from "weakflation" to moderation (from 25% in Q2 to 35%, with the 10 percentage points coming from the weakflation and roaring '20s scenarios). Our U.S. base case assumes solid growth in the 2.0% range with PCE inflation converging towards the Fed's 2% target. Household consumption remains steady enough to drive growth even as the labor market gradually loosens.

With the three regions above comprising about a third of the weighting for emerging markets, our EM base case also calls for moderation (~50%), followed by equal weightings for recession and weakflation (~20% each).

Figure 4
Changes to our regional base cases, complementary scenarios, and their probabilities (%)

	U.S.		Europe		China		EM	
Scenario	Q2	Q3	Q2	Q3	Q2	Q3	Q2	Q3
Moderation	25	35	25	40	70	75	39	49
Weakflation	30	25	40	30	--	--	25	19
NGDP Boom	15	15	5	5	5	5	9	10
Roaring 20s	10	5	--	5	5	5	5	3
Recession	20	20	25	20	20	15	24	19
Stagflation	--	--	5	--	--	--	--	--

Source: PGIM Fixed Income

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SECTION 4

GLOBAL SECTOR OUTLOOKS

04

DEVELOPED MARKET RATES

Outlook: Maintaining a tactical approach as fiscal-related concerns linger and yield curves show signs of re-steepening. Market dynamics may continue to shift as rate differentials apply pressure to certain regions.

- From a quarter-over-quarter perspective, many developed market rate complexes started Q3 in the same nominal vicinity where they started the prior quarter. Yet, the minor, net changes belie a series of notable late-quarter developments with the potential to extend through the second half of the year and beyond.

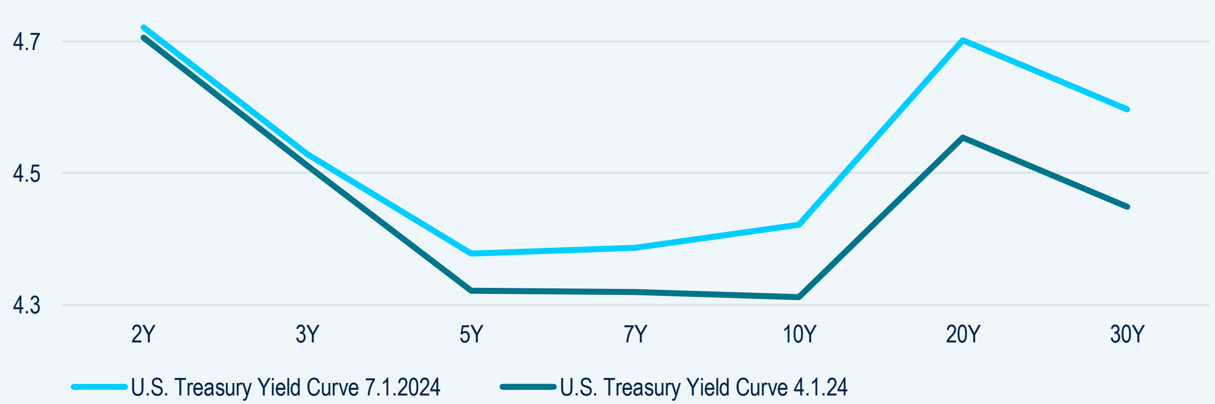
- A common thread throughout our economic and market outlooks pertain to the conspicuous lack of fiscal restraint. As events in late Q2 played out—including the U.S. presidential debate—DM yield curves started to re-steepen from the back end. The steepening stood in contrast to typical, quarter-end buying patterns. While the accompanying chart shows a slight shift along the U.S. curve (2-year to 30-year curve shown for clarity), if present conditions hold, the curve "dis-inversion" may continue amid deficit-related and debt-sustainability concerns.

- The steepening is also indicative of cash securities underperforming derivatives, thus leading to wider swap spreads in the U.S. and Europe as well as pricing implications for credit products that are priced off of swaps. Meanwhile, long-awaited central bank rate cuts may add further momentum to the front end of the curve steepening.

- Another, late-quarter trading development appeared to be driven by declining balance sheet capacity as the general tightening in monetary policies takes hold. Indeed, as the French 10-year yield jumped and the 10-year bund yield declined, the widening spread may have forced some entities to unwind trades, thus adding to the widening pressure, due to balance sheet constraints.

- Prior to the announcement of the snap elections, the spread of 10-year French OATS to 10-year German Bunds stood at about 45 bps, and it subsequently widened to about 80 bps. While that spread compressed into ~65 bps prior to the second round of voting, elevated international ownership of French Treasuries at about 60% remains a source of vulnerability.

The steepening along the U.S. 2y-30y yield curve (%).



Source: Bloomberg

- Although ECB rate cuts—we expect two additional 25 bps cuts to a policy rate of 3.25% by year end—and the central banks' Transmission Protection Instrument are regarded as potential sources of support, comments by ECB President Lagarde late in Q2 also emphasized adherence to fiscal frameworks. That may indicate ECB tolerance for spread widening that is driven by fundamentals, rather than existential developments.

- Recent developments in Japanese markets may also garner attention going forward. While the BoJ may prefer to slowly lift rates to ensure that 2% inflation is sustainable, the rate differential that it is operating under is applying consistent pressure on the yen and raising import costs. It's a situation that may prompt the BoJ to accelerate its rate hikes—perhaps to a pace of two hikes a year—and to pull the start of its quantitative tightening process forward to the second half of 2024.

- Intervention efforts to stabilize the yen are estimated at about $60 billion thus far, which is a size that also carries market implications. Given that Treasuries may be sold to raise cash used to sell dollars and buy yen, that dynamic may also contribute to some selling pressure on cash securities at the front of the curve.

- Shifting to U.S. monetary policy, if the Fed can convey the message that inflation in the 2.5-2.6% area remains above-target due to year-over-year comparisons, we expect at least one Fed cut in 2024 with the mid-December appearing as the most likely meeting for that decision. That said, we think the Fed could implement another cut in the second half of 2024 if given the opportunity. In all, we see 150 bps of Fed rate cuts through 2025.

AGENCY MBS

Outlook: Positive in the short-term given current valuations, limited supply, and potential domestic bank demand. We prefer underweights to production coupons (6% issues and up) as the convexity profile continues to worsen.

- Our positive outlook on the MBS sector is due to a combination of factors, including current valuations, limited supply, and potential domestic bank demand as we move forward. From a general perspective, MBS would benefit if the Fed ultimately cuts rates before year-end and from further declines in implied volatility.

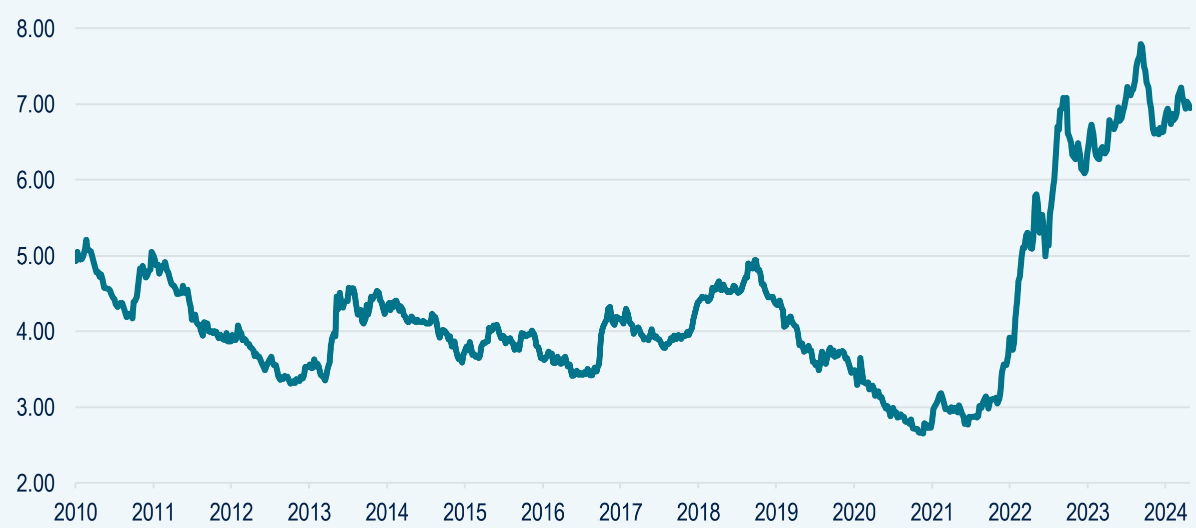
- From a technical perspective, although mortgage rates have fallen from local highs, the lack of affordable housing remains a headwind for mortgage application activity. Year-to-date MBS net supply remains light at less than $60 billion. However, seasonal origination activity is in full swing, with bonds with loan age showing better prepayment speeds.

- On the demand side, buying from banks could increase if deposit pressures ease amid the rate cutting cycle. The Federal Reserve has also indicated final Basel 3 capital rules will be far less restrictive than originally proposed.

- The recent Treasury selloff led to some pressure on MBS durations, but that has recently improved. Looking ahead, most coupons in the MBS Index should behave more in line with expectations at these rate levels.

- The potential risks to our outlook also pertain to the Fed, particularly if it doesn't deliver the policy easing anticipated by markets. Furthermore, if the Fed adjusts its quantitative tightening initiative, it's unlikely to stop MBS from rolling off the balance sheet, and it's also unlikely to add them again in the instance of another quantitative easing program. Finally, expectations of rate cuts have also limited the opportunity set in the sector as convexity risk continues building in production coupons, narrowing investment choices to more positively convex opportunities down in the coupon stack.

MBS issuance has remained light as mortgage rates remain near local highs. Convexity risk is building in production coupons amid rate cut expectations (30-year fixed rate mortgage rate, %)



Source: Bloomberg

Biofuel Producers: Pockets of Opportunity in Brazil

Global biofuel demand is set to expand by 38 billion liters over 2023-2028, according to the IEA, a near 30% increase from the previous five-year period. In fact, total biofuel demand rises 23% to 200 billion liters by 2028 under the IEA's main case, with biodiesel and ethanol accounting for more than two thirds of this growth.[1] This demand is largely expected to be driven by robust global biofuel standards, particularly in emerging economies, like Brazil, Indonesia, and India, where car usage and fuel demand is increasing alongside development.

Though biofuel producers generally remain attractive given expected demand, there are particularly compelling pockets of investment opportunities for corn-based ethanol producers in Brazil. Unlike sugarcane ethanol producers, corn ethanol producers generally do not grow their own feedstock; instead, they procure it from a third party. A key benefit to this is the avoidance of significant capex costs associated with owning and maintaining the land necessary to grow corn and other feedstocks.

Ethanol production in the country has historically come from sugarcane, but this has evolved in recent years. Corn ethanol production in Brazil jumped from 40 million liters in 2014 to 4.4 billion liters in 2023, and production is expected to increase even further: corn-based ethanol is projected to represent 34% of total ethanol production by 2032, up from 23% today.[2,3]

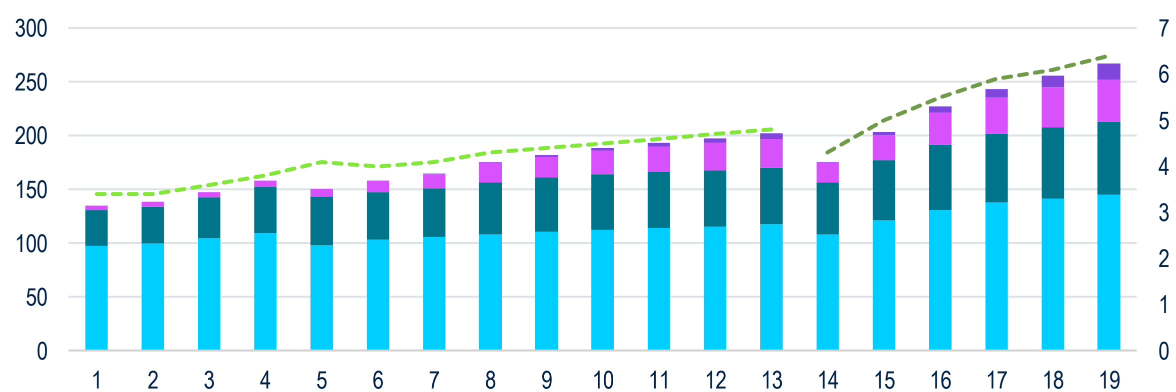
Additionally, many corn ethanol producers benefit from supplementary revenue streams from the sale of animal nutrition products. These are valuable, protein-rich byproducts of the ethanol refining process that can be sold to offset the costs associated with ethanol production. As a result, corn ethanol can be more cost efficient to produce on a net cost basis due to these offsetting revenues.

Booming Brazilian biofuel production

From 1973 to 2022, the share of bioenergy used in Brazil's transport sector increased from just under 1% to nearly 21%.[4] Most of these gains have been within the last two decades, a time during which the Brazilian government began pushing for the introduction of flex fuel vehicles (FFVs) that can run on a variety of biofuel blend ratios. The government of Brazil also advocated for the expansion of a fuel distribution infrastructure capable of supplying

[1] IEA, "Transport biofuels – Renewables 2023"
[2] Based on public disclosure from four large Brazilian biofuel producers.
[3] Farmdoc Daily, "Brazil Emerges as Corn-Ethanol Producer with Expansion of Second Crop Corn," June 30, 2023.
[4] Brazil: Biofuels Annual | USDA Foreign Agricultural Service
5 This type of fuel is most commonly known as E27.
6 USDA "Biofuels Annual," September 5, 2023.

Global biofuel demand, historical, main and accelerated case, 2016-2028
(lhs: billion litres per year; rhs: %)



Source: IEA

a gasoline-ethanol blend and pure ethanol at petrol stations, giving drivers the ability to decide which fuel to buy based on the price differential.

Then, the government of Brazil began stimulating the production of ethanol and biodiesel through fuel blending mandates, with the dual objectives of enabling the country to grow its lucrative domestic biofuels industry and ensure its energy security. Current standards in Brazil require a 27% blend of ethanol in all gasoline.[5] The country's Ministry of Mines and Energy has begun discussions to raise this mandate even further to 30%.[6]

Brazil also mandates a blend of biodiesel into diesel of 14%, and a new proposal approved in March 2024 by the Brazilian Chamber of Deputies would see this threshold rise to 15% in 2025.[7] Playing a key role in igniting Brazil's biofuel production, these are among the most ambitious biofuel standards in the world.

Brazil's net zero ambition also provides tailwinds for biofuel producers

In 2021, Brazil submitted its updated Nationally Determined Contribution (NDC), committing to unconditionally reduce its total greenhouse gas emissions 37% by 2025 and 50% by 2030, compared to 2005 levels. Long-term, Brazil has committed to achieving net zero by 2050.[8]

The National Biofuels Policy in Brazil ("RenovaBio") was launched in December 2017, with the aim of supporting Brazil's commitments under the Paris Agreement. Given biofuels comprise 32% of its total energy supply, Brazil's energy sector is already one of the least carbon-intensive in the world. But there remains plenty of room to further decarbonize, and the country's prioritization of RenovaBio will continue to benefit biofuel producers.

RenovaBio is based on three key instruments. The government of Brazil first sets annual carbon intensity reduction targets for individual fuel distributors over a ten-year time horizon. Then, biofuel producers undergo a certification process for the fuels they produce to ensure the emissions savings of their production is sufficient. Finally, if a producer's products achieve certification, it can issue decarbonization credits ("CBios") equivalent to one metric ton of CO2 equivalent, which can be sold over an exchange.[9] To meet the decarbonization targets set by the government of Brazil, fuel distributors will often purchase CBios from biofuel producers, thus creating an additional revenue stream for them.

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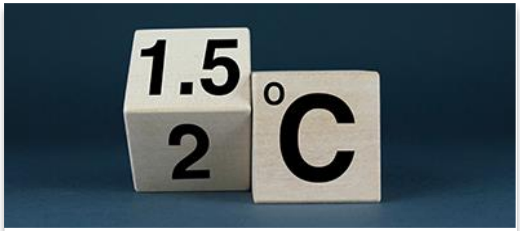


PODCAST

PART 1: NAVIGATING THE LOW CARBON TRANSITION WITH TEMPERATURE ALIGNMENT

We delve deeper into this innovative tool and its role in the low carbon transition.

BLOG

THE CREDIT AND DECARBONIZATION IMPACTS OF SUSTAINABLE AVIATION FUEL

We take a look at the aviation industry and how it contributes about 6% to total global warming annually. We examine what alternatives are available and their respective potential benefits.

7 Fastmarkets, "Brazil's Chamber of Deputies approves proposal to raise biodiesel mandate to 20% in 2030," March 18, 2024.
8 Federative Republic of Brazil, March 21, 2022.
9 USDA "Biofuels Annual," September 5, 2023.

SECURITIZED CREDIT

Outlook: We continue to favor tranches at or near the top-of-capital structure given their attractive relative value and risk-adjusted return potential. With spreads at or through their historical averages, we expect them to remain rangebound, making "carry" the dominant theme throughout 2024. While we acknowledge that strong market technicals could lead to further spread and credit curve compression, we are positioning in shorter spread duration investments at/near the top of the capital structure while being extremely selective and tactical on more credit-sensitive investments as opportunities present themselves. Credit curves are too flat in our view and the downside risks associated with traveling indiscriminately down the capital stack outweigh the potential rewards at this juncture. Thus, we remain very keen on buying only fundamentally cheap bonds and not stretching on quality or credit.

In **CMBS**, a higher-for-longer rate environment continues to pressure cap rates and thus valuations. However, current CRE valuations better reflect the higher interest-rate environment, and we are now closer to the trough in valuations. Our expectation is that property values could decline by about 20% peak to trough, but dispersion will abound with office likely to do the worst. While we believe CRE transaction activity will begin to rebound in the latter half of 2024, higher interest rates and a challenging financing environment may continue to keep activity suppressed. Notwithstanding weak transaction volume, CMBS issuance has rebounded from 2023 levels, led by an especially strong recovery in single asset single borrower issuance. We continue to see value within 5-year conduit AAA securities as spreads look particularly attractive relative to similar tenor IG corporate bonds. Down the stack, we continue to see value in select single-asset single-borrower securities and are selectively adding exposure.

- Within **RMBS**, we continue to see strong housing fundamentals, which we believe will underpin our investments in mortgage credit. While we see higher mortgage rates weighing on affordability and dampening demand, months supply of existing homes (while climbing) remains below the long-term average, reflecting a tight housing market. Strong underwriting practices continue to persist. Thus, we remain positive on mortgage credit instruments against the backdrop of a stable housing market. Notwithstanding, we acknowledge mortgage delinquencies have ticked up slightly in FHA and non-QM mortgage pools. We currently see value in RPL and second-lien bonds, which offer wider spreads than corporates and other non-agency securitized products. Despite our positive view on mortgage credit, valuations of credit risk transfer bonds (largely from Fannie/Freddie mortgages) are stretched as spreads rallied significantly over the last year.

- **CLO** tranches continue to offer attractive relative value compared to many fixed income asset classes. However, we remain cognizant of potential downside scenarios as fundamental headwinds (credit concerns) exist in the underlying bank loans that could outweigh ongoing technical support. While bank loan spreads have been supported by low net 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. Thus, we continue to broadly favor senior CLO tranches in the U.S. and in Europe, but are also seeing total return opportunities in new issue mezzanine tranches. In the U.S., we find value in selling higher price bonds and rotating into higher spread primary transactions. In Europe, the opportunity to purchase bonds at a discount, to a degree, offers total return potential.

- In **ABS**, prime consumer credit remains resilient. Notwithstanding, the effects of inflation and lower disposable income continue to weigh on the weakest consumer segments and is starting to weigh on the near-prime segment. Thus, we remain vigilant for signals suggesting consumer credit is weakening more broadly. We remain positive on spreads in the near term, but are mindful of heavy supply headwinds. We favor top-tier unsecured consumer and subprime auto issuers as performance is strong and relative value is attractive. Significant risk transfer (SRTs) transactions also provide opportunities to get exposure to high-quality consumer assets. Looking forward, we expect increased banking regulation may lead to more opportunities via asset sales or regulatory transactions.

INVESTMENT GRADE CORPORATES

Outlook: Against a backdrop of rising stock prices and relatively low volatility, tight valuations are evident in the IG corporate market. Given relatively tight spread levels and the potential risks laid out below, we are expecting spreads to end Q3 modestly wider than current levels. This may prolong the relative attractiveness of current yield levels.

- As we have previously cited, a key factor supporting the **U.S. IG** market has been the historically high interest rate levels. Therefore, when 10-year Treasury rates started falling from the mid-4.60% area in late May, to the current 4.30%, it was not surprising to see spreads on the IG Index widen slightly.

- Still, there are a number of positive factors that should support the IG market in Q3. First and foremost is the underlying economic backdrop. Our base case is for moderating inflation in the U.S. and a reduced probability of recession. Furthermore, inflation data that are steadily improving towards the Federal Reserve's 2% target is contributing to lower rates, which still appear historically attractive.

- Another strength is that the technical picture in IG remains robust, with steady inflows from pension plans and insurance companies. On the supply side, YTD gross supply has been high, but net supply is expected to taper off in the second half of 2024 as many issuers may have pre-funded ahead of potential volatility.

- Additionally, while merger activity has picked up, much of it has been funded with equity and generally been benign for bondholders.

- Potential market risks include: emerging signs of corporate weakness. While earnings are firm and credit fundamentals remain satisfactory, credit metrics are certainly weaker than the peak.

- Consumer spending. Similarly, U.S. consumers continue to spend, but are now prioritizing essentials, reducing discretionary purchases, and/or trading down. This is due to persistently high inflation, a relatively high cost to borrow, and depleted COVID-era savings.

Considering the historically tight compression between BBB and A spreads, we're favoring allocations of higher credit quality and with enhanced liquidity (percentage points).

Source: Barclays (as of May 2024)

- Increasing event risk. As mentioned earlier, M&A thus far has been benign, but as management teams worry less about a recession and grow accustomed to higher rates for longer, they may become more aggressive in seeking out inorganic growth opportunities.

- 2024 is an incredibly active year for elections globally. We have already seen that out of consensus outcomes in Mexico, India, and France have led to volatility spikes in those markets. Therefore, in the lead up to the U.S. elections in November, U.S. markets may become more volatile.

- From a positioning standpoint, with tight valuations at the overall index level as well as in BB spreads, BBB/A spreads, and 10s/30s spread curves, we look to go up in quality, up in liquidity, and reduce spread duration until better relative value opportunities present themselves. We continue to favor the banking, utility, and pipeline industries.

- The ECB has done its first rate cut and significant downside economic misses are more tail risks. **Euro spreads** now sit 30bps back from U.S. While this is on the cheap side, short-term conviction that they will recompress given all the uncertainties in France is limited. The uncertainty in French politics will cause spreads to sit wider in the near term.

- European spreads are 17 bps tighter YTD. They were hovering around their tights until fear over the French elections gripped the market in mid-June, leading to spreads widening 9 bps. In the near-term, French political uncertainty will continue to be the key focus of the market. With that stated, the French banking fundamental are resilient to any widening as the capital position of these banks are not overweight sovereign bonds (which are typically held at cost). French banks, which widened ~25-30 bps following the election announcements have recovered ~50-60% of the widening as of July 1st.

- For now, the tail risk of far-right / far-left majority or Macron resignation was ruled out after France's second election on July 7th. Risks of a far-right absolute majority was pushed further into the tail as the left and center managed to contain the rise of the right through coalitions.

- Risks that have been around YTD are still in place – e.g., sensitivity to energy prices and their feed through to inflation, Russia /Ukraine, limited economic growth and inflation (albeit this has been falling fast), however these factors have moved further into the tail reflecting less of a need for risk premium.

- In terms of positioning, we are long credit spread risk and neutral spread duration in the Euro funds. EUR risk in our portfolio(s) is at their lows compared to the past few years. Risk was cut as spreads rallied. In the globals, we have a similar risk position with a small underweight in spread duration and a moderate skew to having more risk in the Euro side of the portfolio.

- Assuming OAT-Bund spreads stays within the 65-100 bps range, there is opportunity to add active market overweights to French banks on the front end (in USD, while remaining somewhat flat spread duration risk).

GLOBAL LEVERAGED FINANCE

Outlook: Market technicals remain supportive, yields remain elevated, but spreads appear close to fair value—the market is largely in a carry phase. Geopolitical flare-ups may provide opportunities to add risk. Active and accurate credit selection will continue to be rewarded.

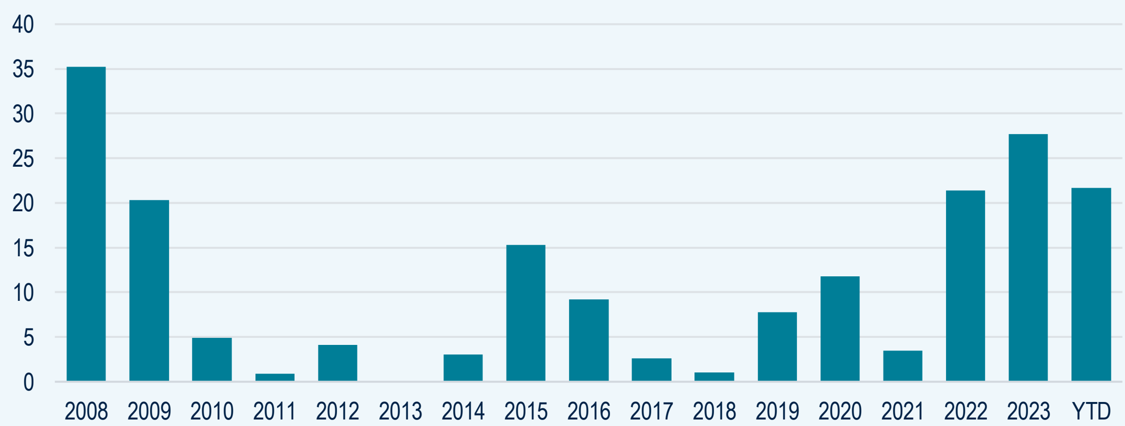
- With **U.S. high yield** spreads hovering near post-GFC tights, we believe they are close to fair value and we expect excess returns to come mostly from carry in Q3 2024. While the economic backdrop and overall high yield fundamentals are generally supportive of tighter spread levels, we believe the market is underpricing global geopolitical risk and uncertainty regarding the U.S. elections. Therefore, we maintain a slightly cautious outlook. That said, any geopolitical flare-up will likely provide an opportunity to add risk, as most instances typically cause only temporary spread widening.

- While the credit ratings profile of the high yield market is very strong by historical standards and balance sheets for high yield issuers remain solid, fundamentals are no longer on an improving trajectory as revenue growth appears to be stalling. Overall, U.S. high yield issuers are enjoying margin expansion and able to pass through and hold onto price increases. However, higher costs are leading to some margin deterioration in certain sectors.

- The lagged effects of higher policy rates and tighter lending standards from banks remain headwinds to economic growth. Unemployment remains at historically low levels, fueling continued consumption. However, should the labor market weaken and consumers pull back, downward pressures on corporate earnings and profit margins will increase. Moreover, as high yield issuers are forced to refinance debt at higher interest rates, higher interest costs will continue to lead to continued deterioration in coverage ratios—albeit from very high levels.

- Due to the strength of most issuer's balance sheets, the absence of a significant maturity wall through 2024, manageable maturities in 2025 and 2026, and the declining probability of a recession, we expect default rates to remain flat or even decline over the next 12 months. That said, the increased frequency of aggressive liability management exercises and distressed exchanges from sponsored issuers bears watching as the $21.7 billion in activity across high yield bonds and loans thus far in 2024 already ranks as the third highest annual total.

Distressed Exchange Activity Across High Yield and Loans ($B)



Source: JP Morgan

■ Meanwhile, the technical backdrop remains supportive due to a variety of factors, including muted net new supply. Given the continued supportive market technical, we expect spreads to remain flat or to slightly tighten over the near term, with ample tail risk from risks outside of the high yield market. Longer term, we are attuned to the risks to the economy from a sustained period of high real interest rates.

■ We are maintaining overweights to home construction as well as the electric and independent energy sector names, while maintaining underweights in technology, retailers, consumer cyclical services, media & entertainment, and property & casualty. We remain overweight cable & satellite but are trimming our exposure to the sector. We are currently looking to add high-quality cash bonds with a preference for short duration issues. Due to the idiosyncratic nature of the market, it is possible to generate alpha in the CCC-and-below portion of the market through careful credit selection.

■ Following the strong first half returns, we raised our **U.S. leveraged loan** total return forecast to 8.0-8.5% in 2024. Our forecast is supported by high all-in current coupons and yields, strong CLO formation, continued inflows into bank loan funds, loan paydowns, and modest net new supply as refinancing and repricing activity continues to make up the bulk of capital market activity. Embedded into our forecast is the strong total returns experienced thus far in 2024 and the expectation of higher-for-longer SOFR rates, along with the expectation that loan prices will hover around current levels barring any unforeseen macro event.

■ Loan defaults rates eased in recent months but remain slightly above their long-term average amid rising corporate headwinds and higher interest rates. We expect the higher cost of capital to continue to pressure free cash flows of lower-quality, sponsor-owned companies for the remainder of 2024. However, we don't anticipate a significant rise in default rates through the remainder of 2024, with loan default rates (including distressed exchanges) expected to remain in the 3-5.5% range through year-end 2024 and cumulative defaults of 10% through 2025.

■ 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.

■ Spreads for **European high yield** and **European loans** tightened significantly in 1H24 as markets priced in a lower probability of recession over the next few months and market technicals remained supportive. We expect spreads to remain rangebound in Q3 barring any unforeseen shocks. Yields remain attractive on an absolute basis and we expect both the high yield and loan markets to generate positive excess returns over the next 12 months on a probability-adjusted basis for various economic scenarios.

■ We expect defaults to remain around current levels for the next 12 months. The vast majority of the market is high quality, performing businesses, keeping defaults at these relatively benign and manageable levels. That said, there remains a dispersed and dislocated tail of default candidates–carefully selecting overweights and underweights in this part of the market will continue to be a meaningful performance driver.

■ In terms of positioning, we are running market neutral levels of risk given our view that spreads are at / close to fair value. We are backing our top relative value picks to generate alpha. Any short-term volatility from macro events (e.g. the French elections) could present an opportunity to add risk. Ultimately, we think active and accurate credit selection will continue to be rewarded.

EMERGING MARKET DEBT

Outlook: Constructive on EM hard currency, but mindful of global election outcomes and policy headwinds. Short-term dislocations may surface if risk sentiment deteriorates. In local rates and FX, the persistently strong U.S. dollar and the repricing of Fed rate-cut expectations argues for tactical relative-value positioning.

■ We continue to view EM through the constructive fundamental prism, but our short-term positioning is focused on factors that can outweigh the carry advantage in EM. These include the potential slowing of the U.S. economy, global fiscal pressures, and shifting domestic and geopolitical alliances. While retail fund flows continue to be negative across EMD, two counterpoints add context to that sentiment: 1) significant supply has been well absorbed, and a negative credit funding shock is unlikely if the backdrop deteriorates; and 2) portfolio flows and FDI flows remain positive.

■ From a long-term perspective, our strategic allocations to EM remain focused on a set of central premises. These include the critical role that EMs play in supply chain realignments, the commodity supply/demand relevance to energy transition and to broader geopolitical determinants, and how EM countries will effectively leverage their role vis-à-vis the "Great Power Competition" (i.e., how they best utilize willingness of DM/China to accommodate financing/partnerships/alliances to their best advantage).

EM Hard-Currency Government Bonds

■ The prospects for hard currency EM debt look appealing, but there are headwinds that require deliberate positioning, and the opportunity set is shifting with valuations. The increased probability of moderate economic conditions in the U.S. and Europe—coupled with solid EM growth and the high carry of EM hard currency sovereigns—is very attractive. While China growth has surprised to the upside, without sufficient stabilization in the property market and additional stimulus, sentiment is unlikely to recover enough to help consumption and rebalance growth over the medium term. Moreover, geopolitical headwinds persist: we are no closer to a resolution in Ukraine, U.S.-China tensions will likely increase, and a ceasefire in Israel remains uncertain. Elections within EM countries continue to surprise, and the U.S. election in November adds another dose of uncertainty.

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	-6.7%	-3.4%	-1.8%	-0.2%	1.4%	3.0%	4.6%	6.3%	7.9%	9.5%
50	-5.1%	-1.8%	-0.2%	1.4%	3.0%	4.6%	6.3%	7.9%	9.5%	11.1%
0	-3.4%	-0.2%	1.4%	3.0%	4.6%	6.3%	7.9%	9.5%	11.1%	12.7%
-50	-1.8%	1.4%	3.0%	4.6%	6.3%	7.9%	9.5%	11.1%	12.7%	14.3%
-100	-0.2%	3.0%	4.6%	6.3%	7.9%	9.5%	11.1%	12.7%	14.3%	16.0%
-150	1.4%	4.6%	6.3%	7.9%	9.5%	11.1%	12.7%	14.3%	16.0%	17.6%
-200	3.0%	6.3%	7.9%	9.5%	11.1%	12.7%	14.3%	16.0%	17.6%	19.2%

Nominal GDP Boom **10%**

Weakflation **19%**

Soft landing **49%**

Roaring 2020s **3%**

Recession **19%**

Source: PGIM Fixed Income

- Within the BBB and BB issuers, carry remains very attractive with solid spread pick-ups over developed market corporates and sovereigns. However, most countries trade at the tight end of historical ranges, and bottom-up analysis remains as necessary as ever. Risks remain, particularly from domestic politics. June saw a number of election surprises (e.g., Mexico's Morena party winning significant majorities in congress, while India's BJP party and South Africa's ANC need to form coalitions to govern).

- In Mexico, the Morena party has the ability to reform the constitution, which could potentially diminish "checks and balances" and increase the role of the state. This could jeopardize foreign direct investment and potentially impact Mexico's investment grade status down the road. It could also benefit Pemex as Scheinbaum, a former energy engineer and climate activist, has a focus on ESG and may look to improve Pemex's balance sheet through liability management exercises. We see opportunity in Pemex and Mexican quasi-sovereigns and corporates but prefer to remain underweight the sovereign. While the elections in India and South Africa also surprised, the outcomes likely have a smaller impact on spread markets. India's growth may slow, but it will remain elevated and supportive of our corporate and quasi-sovereign positioning. South African policy needs to be monitored, but thus far the formation of the GNU seems to have met expectations and the quasi-sovereigns remain attractive.

- Elsewhere, we see solid opportunities in IG sovereigns Saudi Arabia and Romania and quasi-sovereigns, particularly in Qatar, Indonesia, and UAE. The opportunity set expands within BB issuers, with healthy spreads in Brazil, Serbia, Ivory Coast, Colombia, Guatemala, Costa Rica, and Morocco sovereigns and quasi-sovereigns.

- Within the lower-quality issuers, we are seeing improvement amongst several stressed-performing issuers that have drawn concerns for some time. Egypt has grown reserves meaningfully, Turkey is implementing policy adjustments, Ecuador's fiscal adjustment appears credible with IMF support, Pakistan has a stable government while adhering to IMF conditions, Nigeria has removed costly subsidies, and even Argentina is making progress. However, the durability of progress is not a given and politics remain fickle in many situations. U.S. elections may have an impact on multi-lateral financing, which has been concessionary over the last four years, therefore the sustainability of reforms is imperative. Within the stressed-performing space, we believe Ecuador, Egypt, Angola, Senegal, and Pakistan offer very good value for their risks.

- Within the non-performing space, Zambia has just completed a restructuring, while Ghana and Sri Lanka appear to be close to restructuring. We see good opportunities in both Zambia and Ghana based on their ability to grow and reduce exit yields post their respective restructurings. We have less faith in Sri Lanka's ability to reduce its bloated state-owned enterprise sector and produce sustainable results once it restructures. The situations in Ukraine and Venezuela/PDVSA remain very fluid. However, select securities in both appear to offer good risk-reward profiles based on current prices, but sizing is key.

- Longer term, there are a number of tailwinds that will help EM spreads: EM-DM growth differentials are high and expected to widen, EMs are maturing from the perspective of debt structure, geopolitical importance, as well as GDP growth, and EM economies are set to benefit from U.S.-China competition (via supply chain reorganization and financing) and favorable demographics.

EM Hard-Currency Corporate Bonds

- Although EM corporate spreads have tightened and are now well through their historical average and, in some cases, have compressed close to fair value, we believe the outlook is still favorable given the ~7% yield on the asset class, resilient fundamentals, negative net supply, and supportive macroeconomic conditions. The maturity wall of 2025 and 2026 has been extended, and we expect EM corporate high yield defaults to remain within the historical range of 3-4%, in-line with developed markets. Other points of support include fewer idiosyncratic surprises, non-dedicated investors who have shown resurgence in appetite for the asset class, and, while gross issuance is higher than expected, net financing will likely remain negative.

- We still see the best value in EM Corporate BBs at current spread levels of 320 bps and select longer-dated BBB issuers at current spread levels of around 175 bps. We continue to maintain core overweights in Brazil, Mexico, and India corporates amidst the countries' respective political developments. We added some Turkish corporates earlier this year at very attractive valuations, and selectively added some copper and zinc names given the strong commodity outlook. We also like banking tier-2 issues in Peru, Colombia, and Thailand. Some semi-distressed issuers in sectors, such as chemicals and LatAm telecom, have recovered strongly from the lows, but we believe there could be some further upside given stabilizing fundamentals. We remain very cautious on China but have covered some China high yield underweights in relevant portfolios. Risks to the asset class include credit stress related to higher funding costs, an economic slowdown, and geopolitical risk

EM Local-Currency Rates

- So far in 2024, EM local rates have underperformed core rates. Broad U.S. dollar strength, sticky service inflation, widening fiscal deficits, and recent election results have not only caused the underperformance, but they have also interrupted monetary easing cycles in many countries, i.e., Brazil. Mexico, Colombia, Indonesia, and Hungary.

- We are constructive on local markets from a top-down perspective. With the U.S. economy showing some signs of a slowdown and the Fed's presumed rate cuts gradually materializing, we believe that a repeat of March/April selloff in the U.S. rates is unlikely. At 6.60%, the Index yield is still in the top end of the year-to-date range of 6.10-6.65%. If the Fed cuts rates in September, it would provide a tailwind to an oversold asset class.

- From a bottom-up perspective, widening fiscal deficits in most EM countries and recent election surprises in South Africa, Mexico and India present some challenges to the "country selection" process. Based on inflation trends, we see a wide dispersion among EM central banks' monetary stance. Brazil, Chile, Czech, and Hungary are closer to ending their easing cycle, while Mexico, Colombia, and Peru have scope to continue their easing. Central banks in Asia and South Africa are likely waiting for the Fed before cutting rates. A further tightening in Indonesia cannot be ruled out.

- Given the poor performance of EM local rates this year, we believe that many of the concerns are likely priced in, and Q3 should be played from the overweight side. In our barbell approach, we are overweight high beta names, such as Brazil, Mexico, and Hungary, and low beta names, such as India, Czech, and Thailand. Our preferred tenors are 5 to 10 years. Main risks to our constructive outlook stem from a possible resurgence of inflation in the U.S. leading to a selloff in U.S. rates and a failure to consolidate fiscal deficits in Brazil. Mexico, Colombia, South Africa, and Indonesia. As a result, we are measured in our sizing of our local rates positions.

EM Currencies

- Bottom-up election outcomes and/or fiscal concerns (Mexico, Brazil, Colombia, and Indonesia) coupled with a top-down undercurrent of slowing global nominal growth, prompted investors to demand higher risk premiums via cheaper currencies so far in 2024. At the same time, the Fed appears in no hurry to cut rates and is for now comfortable with a "higher-for-longer" policy stance. In the early stages of Q3, we believe central bank policy divergence (whereby the Fed is slow to cut rates while EM central banks continue to cut) is supportive of U.S. dollar strength.

- While the combination of U.S. dollar strength, slowing nominal growth, and election and fiscal concerns in select countries seems like an unfavorable backdrop for EM currencies, a few themes provide reason for optimism as Q3 progresses.

- To begin with, EM currencies have already repriced—by a lot in some cases (MXN, BRL, COP, IDR, and ASIA as a whole). Moreover, recent U.S. CPI prints have been encouraging and slowing growth is shifting the asymmetry towards potentially more rather than fewer Fed cuts. Additionally, there are select high carry opportunities with improving bottom-up stories (e.g., Turkey, Egypt) and attractive opportunities in stable bottom-up stories (e.g., India, Poland).

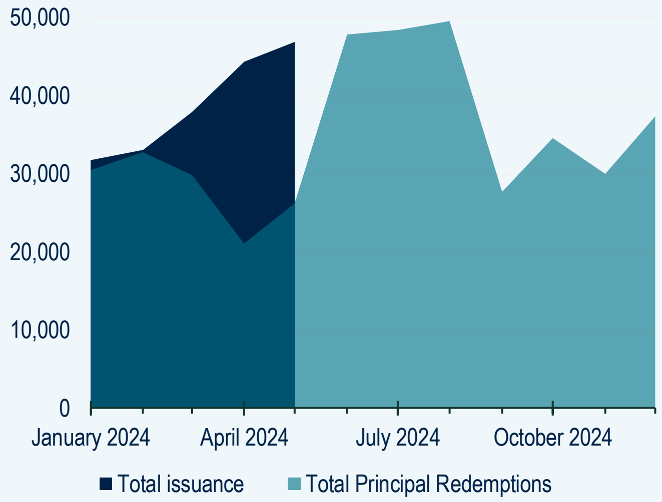
- Given the underperformance in the first half of 2024 and the evolving outlook for Fed rate cuts, we would not be surprised if the first half's negative performance eventually leads to a positive second half. While top-down and bottom-up concerns are front and center, we could see the backdrop improve toward the end of Q3 even if more repricing occurs and a more dovish Fed emerges. For now, we are positioned predominantly in relative value and have a small, long U.S. dollar bias. We still favor high-carry over low-carry currencies. Our top longs are the Turkish lira, the Egyptian pound, the Brazilian real, the Indian rupee, and the Indonesia rupiah, while top shorts include the Chinese yuan, the Thai baht, the South Korean won, the Czech koruna, and the Taiwan dollar.

MUNICIPAL BONDS

Outlook: We believe the market will continue to be supportive and stable. Absolute yields remain attractive by historical standards along with muni/Treasury yield ratios. This should continue to drive investor demand, causing spreads to remain tight. In addition, elevated supply is expected to fade as we approach election season and BAB refinancings die down, further supporting market performance. As investors continue to acclimate to the "higher for longer" interest-rate environment, rangebound trading in Treasuries should also be a supportive technical.

- Last quarter, markets came to the realization that the aggressive cut schedule initially priced in would not materialize. Despite rates repricing higher, spreads tightened significantly. This led to healthy performance from HY, while IG performance lagged.
- To date, muni issuance is running ~35% ahead of last year. The elevated supply was caused by: 1) a decrease in rate vol (MOVE down ~25% YTD) and issuers adjusting to the higher-rate environment; 2) a recognition of deferred maintenance and a stabilization of project cost as inflation comes down (Transportation running 75% above last year and Healthcare running 127% above last year); 3) BAB calls moving money from taxable to tax exempt (~$12billion); and 4) election years typically have elevated issuance in 1H vs 2H. With that stated, an estimated $120 billion of reinvestment should power market performance through the summer.
- Fundamentals remain a bright spot for munis as tax collections remain healthy and rainy day funds robust. Two states, MD and CA, have negative outlooks and CT's outlook was upgraded to a positive. In fact, upgrades continue to outpace downgrades, although the ~1.3x ratio pales in comparison to last year's ~3.6x, which was the highest since 2009 and 2007.
- **Positioning:** We are sanguine on states' credit quality, preferring to pick up certain state names that are trading wider. The most challenged sectors by the rating agencies have been higher education and healthcare. More generally, we're remaining up in credit quality and assessing off-the-run structures that enhance yield, but do not increase credit risk.
- **Tax Policies:** With tax cuts rolling off in 2025, the demand picture for munis could be materially reshaped, depending on the election outcomes. For example, it remains to be seen if either candidate will target the tax exemption as a means of paying for other spending priorities.
- **Taxable Munis**: Other than a shrinking taxable market as a result of the BAB financing, taxable muni activity has been muted this year. A dearth of issuance and an active corporate market has removed spotlight from the sector.

Total Muni Issuance Vs Redemptions
(Par Amount (USD Millions)



Source: Bloomberg as of June 2024.

ERP subsidy cuts
(% by year)

Source: Barclays Research and IRS as of March 2024.

PGIM FIXED INCOME

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]

NEGATIVE VIEW — POSITIVE VIEW

Market Scores

U.S. — Europe

EM

Sector	Short-term Outlook	Long-term (1-yr) Outlook[1]
DM Rates	Maintaining a tactical approach as fiscal-related concerns linger and yield curves show signs of re-steepening. Market dynamics may continue to shift as rate differentials apply pressure to certain regions.	U.S. UK Europe Japan
Agency MBS	Positive in the short-term given current valuations, limited supply, and potential domestic bank demand. We prefer underweights to production coupons (6% issues and up) as the convexity profile continues to worsen.	Agency MBS
Securitized Credit	We continue to favor tranches at or near the top-of-capital structure given their attractive relative value and risk-adjusted return potential. With spreads at or through their historical averages, we expect them to remain rangebound, making "carry" the dominant theme throughout 2024. We are positioning in shorter spread duration investments at/near the top of the capital structure while being extremely selective and tactical on more credit-sensitive investments as opportunities present themselves. Credit curves are too flat in our view and the downside risks associated with traveling indiscriminately down the capital stack outweigh the potential rewards at this juncture. Thus, we remain very keen on buying only fundamentally cheap bonds and not stretching on quality or credit.	CMBS ABS CLOs
Global IG Corporates	Against a backdrop of rising stock prices and relatively low volatility, tight valuations are evident in the IG corporate market. Given relatively tight spread levels and the potential risks laid out below, we are expecting spreads to end Q3 modestly wider than current levels. This may prolong the relative attractiveness of current yield levels.	U.S. Corps. 1-10 European Corps. 1-5 U.S. Corps. 10+ European Corps. 5+
Global Leveraged Finance	Market technicals remain supportive, yields remain elevated, but spreads appear close to fair value—the market is largely in a carry phase. Geopolitical flare-ups may provide opportunities to add risk. Active and accurate credit selection will continue to be rewarded.	U.S. High Yield 1-5 Euro High Yield BB U.S. High Yield 5+ Euro High Yield B and below U.S. Leveraged Loans Euro Leveraged Loans
EM Debt	Constructive on EM hard currency, but mindful of global election outcomes and policy headwinds. Short-term dislocations may surface if risk sentiment deteriorates. In local rates and FX, the persistently strong U.S. dollar and the repricing of Fed rate-cut expectations argues for tactical relative-value positioning.	Sov. Hard Currency IG EMFX[2] Sov. Hard Currency HY Corps. IG Local rates[2] Corps. HY
Municipal Bonds	We believe the market will continue to be supportive and stable. Absolute yields remain attractive by historical standards along with M/T ratios. This should continue to drive investor demand, causing spreads to remain tight. In addition, elevated supply is expected to fade as we approach election season and BAB refinancings die down, further supporting market performance. As investors continue to acclimate to the "higher for longer" interest rate environment, rangebound trading in Treasuries should also be a supportive technical.	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.

GEOPOLITCAL OUTLOOK SUMMARY

With no shortage of geopolitical hotspots, the following summary page provides our scenario analysis of the respective situations along with signposts to watch over the coming months and quarters.

Key geopolitical risks (base case and assumptions)	Signposts	Benign Case	Adverse Case	Direction and impact
Escalation of Russia's War vs Ukraine Attritional war with risk of escalation **(80%)** **Assumptions:** Positional warfare persists, with no major changes to frontlines.	Continued support from West. Battlefield breakthroughs (lack thereof). Secondary sanctions. Next U.S. President.	Mutual understanding that victory is impossible. Fragile ceasefire with external participation. West -Russia security talks	Faced w/ defeat Russia responds via WMDs, risking escalation with NATO **(5%)**	↓ Rising/ high
Expansion of Israel - Hamas War Conflict remains limited to Gaza **(50%)** **Assumptions:** Major regional players against expanded conflict. KSA & Iran truce holds up. Israel-Iran locked in shadow war despite "change in equation" retaliatory attacks.	Diplomatic progress; Israeli and U.S. politics. Iran's actions and China's engagement.	Long-term ceasefire. Hostage diplomacy succeeds. PA-led admin takes over. Israel accepts discussion of two-state solution—Gaza reconstruction.	Wider ME conflict in Gulf region, including the U.S. and Iran KSA-Iran truce breaks down **(40%)**	↔ Rising/ high
Escalating Military Tensions on the Korean Peninsula NK's nuclear and diplomatic coercion **(80%)** **Assumptions:** Build up of conventional/ nuclear capability to undermine security status quo and coerce diplomatic recognition as nuclear state	Advance of nuclear program. Perceived strength of U.S./allies' deterrence. China and Russia's relationship with NK.	Return to status quo. Denuclearization talks resume in exchange for sanctions relief.	War with SK, including potential use of nuclear weapons. Nightmare scenario—attack coincides with China's invasion of Taiwan **(15%)**	↓ Rising/ high
Escalating Dispute Between China and Philippines Uneasy status quo with risks of accidental military confrontation **(65%)** **Assumptions:** Philippines strengthening military ties with U.S.; challenging China's presence in disputed islands	Continuation of China's coercive actions against Manila; re-launch of bilateral, regional treaty talks.	Pre-Marcos status quo: Philippines and China launch negotiations resulting in cooperation to address disputes.	Military conflict. Fear of wider credibility gap forces US to act **(25%)**	↓ Rising/ high
China's Military Invasion of Taiwan China continues to erode status quo in preparation for takeover short of war **(85%)** **Assumptions:** China prepares ground for reunification using coercive tools / deterrence against U.S.' involvement.	Continued U.S. support and its "strategic ambiguity" policy. Whether Taiwan's Lai signals drive for independence.	Current status quo broadly persists.	War over Taiwan: Taipei pushes for & US supports independence. Misunderstandings lead to Chinese invasion **(5%)**	↔ Stable/ High

Source: PGIM Fixed Income.

SUMMARY OF MARKET PERFORMANCE

Sector		Subsector	Spread change (bps) Q2	SOFR OAS 6/30/24
CMBS	CMBS: Conduit AAA	First-pay 10-year	10	135
	CMBS: Conduit BBB-	BBB-	-112	666
	CMBS: SASB – Senior	AAA	20	170
	CMBS: SASB – Mezz	BBB-	10	300
	CMBS: Agency Multifamily	Senior	3	87
Non-Agency RMBS	Legacy	RPL Senior	4	147
	Legacy	'06/'07 Alt-A	5	240
	GSE Risk-Sharing	M2	-20	160
CLOs	CLO 2.0	AAA	-15	135
	CLO 2.0	AA	-25	170
	CLO 2.0	BBB	-50	295
ABS	Unsecured Consumer Loan ABS	Seniors	15	136
	Unsecured Consumer Loan ABS	Class B	0	171
	Refi Private Student Loan	Seniors	5	141
	Credit Card ABS	AAA	8	69

Source: PGIM Fixed Income.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q2	YTD	Q2	YTD	6/30/24
U.S. Corps.	-0.09	-0.49	4	5	94
European Corps.	0.08	0.54	6	-18	120

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 %
	Q2	YTD	Q2	YTD	6/30/24
EM Hard Currency	0.30	2.34	49	7	391
EM Local (Hedged)	0.54	0.74	33	41	6.60
EMFX	-0.27	-1.38	-31	-118	7.75
EM Corps.	1.49	3.85	-9	-46	267

Source: J.P. Morgan.

	Total return (%)		Spread change (bps)		OAS/ DM (bps)
	Q2	YTD	Q2	YTD	6/30/24
U.S. High Yield	1.09	2.58	10	-14	309
Euro High Yield	1.39	3.23	12	-29	370
U.S. Leveraged Loans	1.86	4.44	4	-22	524
Euro Leveraged Loans	2.39	4.98	-19	-37	497

Source: ICE BofAML and Credit Suisse.

	Total return (%)	
	Q2	YTD
High Grade Tax-exempt	-0.02	-0.40
High Yield Tax-exempt	2.59	4.14
Long Taxable Munis Agg. Eligible	-0.64	-0.90

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 June 30, 2024.

IMPORTANT INFORMATION

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

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INDEX DESCRIPTIONS

U.S. INVESTMENT GRADE CORPORATE BONDS

Bloomberg U.S. Corporate Bond Index: The Bloomberg U.S. Investment Grade Corporate Bond Index covers U.S.D-denominated, investment-grade, fixed-rate or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. 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.

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.

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.

The **S&P 500®** is widely regarded as the best single gauge of large-cap U.S. equities. There is over U.S.D 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately U.S.D 3.4 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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