1st QUARTER OUTLOOK

PGIM FIXED INCOME

January 2018

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When Fiscal and Monetary Policies Diverge

The two diverging factors set to unfold in 2018—a broad loosening of U.S. fiscal policy countered by gradually tightening monetary policies among some of the world's major central banks—underscore investors' challenge of recognizing directional cues throughout the year. In this edition of PGIM Fixed Income's Quarterly Outlook, we examine what these signals might look like across the fixed income markets, the global economy, and the various corporate sectors.

- In "The Bad Year for Bonds—That Wasn't," Robert Tipp, Chief Investment Strategist, looks at how receding monetary stimulus could promote the continuation of a moderate economic cycle and support stable market conditions going forward.
- "Four Developments in 2018 and Beyond," by Nathan Sheets, Chief Economist and Head of Global Macroeconomic Research, lays out four key points that could determine global economic performance in 2018 and in the years to come.
- Reduced excise tax on alcohol makers, lower orphan drug credits, and a new BEAT tax—these are only a few of the provisions in the newly passed U.S. Tax Cuts and Jobs Act. Our team of credit analysts provides a summary of how U.S. tax reform may affect certain industries, and our Sector Outlooks detail how the Act may impact various asset classes.

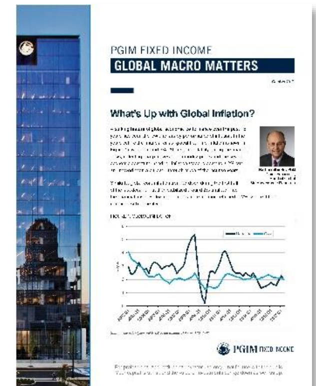
Recent Thought Leadership on PGIMFixedIncome.com (Click Title or Image to View)

U.S. TAX REFORM: THE GLOBAL IMPLICATIONS

FOLLOWING IN JAPAN'S FOOTSTEPS: HAVE THE U.S. AND EURO AREA SEEN A "LOST DECADE"?

FROM GREECE TO BONDHOLDERS WITH LOVE

WHAT'S UP WITH GLOBAL INFLATION?



Sector Views

Developed Market Rates (page 11, click to view): Tactically constructive. We'll continue to take our positioning cues from upcoming developments within the JGB, Bund, and Treasury markets. These could include stabilizing intermediate yields in the U.S. and the start of curve flattening in Europe.

Agency MBS (page 11): Underweight in favor of high-quality spread sectors and rates, respectively. We prefer 3.5% issues for better carry opportunities and remain underweight 15-year and GNMA 2 issues.

Structured Products (page 12): We remain very positive on top-of-the-capital structure issues, especially CMBS and CLOs. For legacy RMBS, we would be content to earn carry at current spread levels. We are negative on conduit CMBS mezzanine tranches. We are increasingly looking at financing trades as spreads on the underlying assets are tight and the demand for leverage is high.

Corporate Debt (page 13): Modestly positive given favorable technicals and fundamentals, strong investor demand, and economic growth momentum. Still favor U.S. money center banks. Tax reform could provide further upside.

Global Leveraged Finance (page 15): Positive in the near term as fundamentals continue to improve and technicals remain supportive. Longer term, we are more cautious on U.S. high yield given tight spreads and elevated tail risks. Our constructive view on European high yield is based on expectations for modest spread tightening, reduced political risk, and a decent macro environment in Europe.

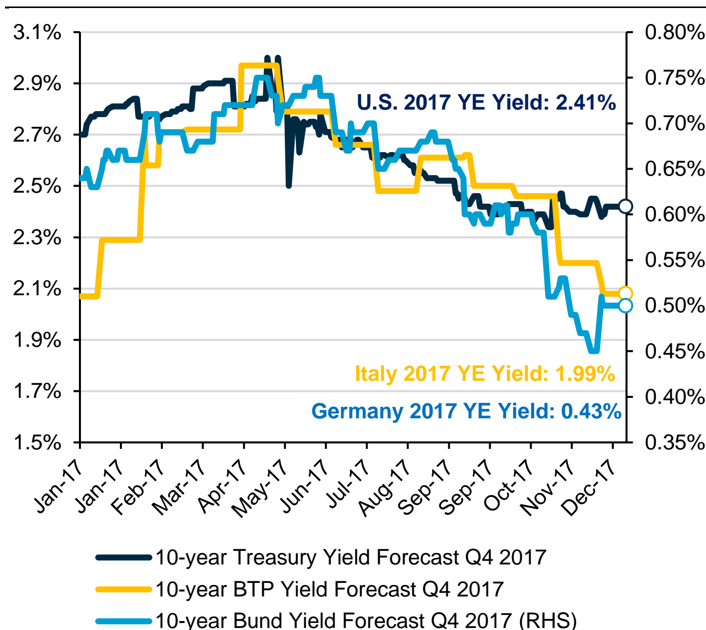
Emerging Market Debt (page 17—also look for an excerpt of our upcoming white paper, "Loco for Emerging Markets Local Debt and FX"): Positive. Opportunities include hard currency assets that trade wide to the major benchmarks and EM local rates with high real yields. EMFX stands to benefit from a stable-to-lower dollar as EM economic growth continues to outpace developed market growth.

Municipal Bonds (page 18): Positive. Extremely favorable technicals in Q1 could lead to solid outperformance vs. Treasuries.

The Bad Year for Bonds—That Wasn't

Let's face it: 2017 was not expected to be a good year for bonds. There was so much for the bond market to fear. European and Japanese interest rates had risen as the ECB and BoJ began their respective stylized tapering. The U.S. had its Republican sweep, bringing with it expectations for pro-cyclical fiscal stimuli and upside risks for Fed rate hikes. All said, this confluence was expected to finally torpedo the decades-old bond bull market. Consensus year-end forecasts for the 10-year Treasury and Bund yields rose as high as 3.0% and 75 bps, respectively. And Italy, suffering from both perennial fiscal concerns and political anxieties (which pretty much spanned Europe), saw the year-end forecast for the 10-year BTP yield rise as high as 3.0%.

FORECASTS PROJECTED HIGHER YIELDS IN 2017 BEFORE RETURNING TO REALITY. FORECASTS AGAIN CALL FOR HIGHER YIELDS IN 2018.



Source: Bloomberg as of December 2017.

While European political fears turned out to be a bit overblown, all of the other fears were more or less grounded. The ECB and BoJ are continuing to reduce their purchases, fiscal stimulus in the U.S. is on the way, and the world's economy generally continues to improve, as detailed in the following Global Economic Outlook. But thanks to positive yield curves lending a little yield and roll down advantage relative to cash, coupled with a little more spread tightening, 2017 confounded many of the initial expectations and turned out to be yet another solid year for fixed income with broad benchmarks generally outperforming cash and, as expected, the higher-yielding sectors putting in particularly impressive performances as depicted in the following table of returns.

	Total Return (%)				
Multi-Sector	**Q4 2017**	**2017**	**2016**	**2015**	**2014**
Global Agg. Hedged	0.80	3.04	4.0	1.0	7.6
U.S. Aggregate	0.39	3.54	2.7	0.6	6.0
Euro Aggregate	0.55	0.68	3.3	1.0	11.1
Yen Aggregate	0.35	0.18	3.0	1.1	4.3
Global Aggregate	1.08	7.39	2.1	-3.2	0.6
Individual Sectors	**Q4 2017**	**2017**	**2016**	**2015**	**2014**
U.S. Long IG Corporates	3.34	12.09	11.0	-4.6	15.7
EM Currencies	2.00	11.54	3.5	-7.6	-7.0
U.S. IG Corporate Bonds	1.17	6.42	6.1	-0.7	7.5
EM Debt Hard Currency	1.16	10.26	10.2	1.2	7.4
U.S. Leveraged Loans	1.09	4.09	9.9	-0.4	2.1
Municipal Bonds	0.75	5.45	0.3	3.3	9.1
European High Yield Bonds	0.72	6.79	10.8	1.3	5.1
European IG Corporate	0.64	2.41	4.7	-0.6	8.4
European Leveraged Loans	0.53	3.72	7.0	3.6	2.1
U.S. High Yield Bonds	0.41	7.48	17.5	-4.6	2.5
CMBS	0.35	3.35	3.3	1.0	3.9
Mortgage-Backed (Agency)	0.15	2.47	1.7	1.5	6.2
U.S. Treasuries	0.05	2.31	1.0	0.8	5.1
EM Local (Hedged)	0.03	3.68	4.7	-2.2	3.2

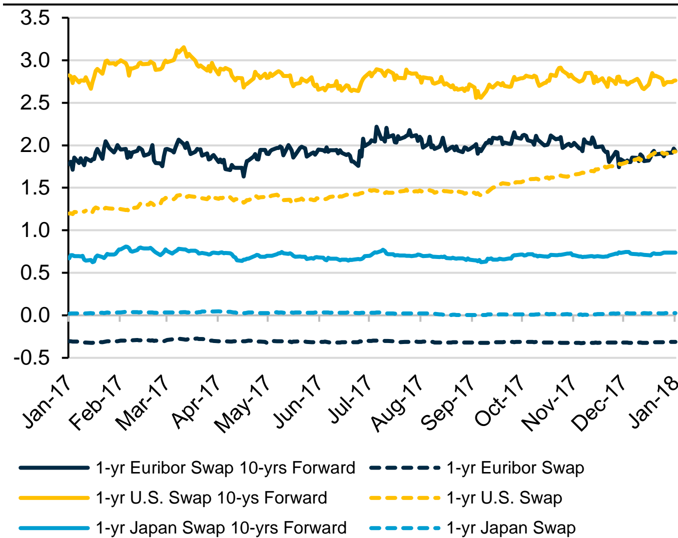
Sources: Bloomberg Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Senior Secured Loans (Credit Suisse). Performance is for representative indices as of December 31, 2017. See Notice for full index names. Past performance is not a guarantee or a reliable indicator of future results. An investment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

Economic Optimism Still No Match for the Bond Market?

Our economic outlook for 2018 is one of guarded optimism and, in many respects, an economic and policy repeat of 2017. As a result, our market outlook calls for a similar, but perhaps more muted, result for the fixed income markets in 2018—i.e., expect bonds to outperform cash, with perhaps even a bit less volatility, particularly in long-term interest rates. How is that possible?

First, the withdrawal of monetary stimulus has two key features: 1) it is likely to continue at a gradual pace, and 2) it should continue to be well telegraphed. As a result, as we have seen in the U.S. over the past several quarters, the markets should be able to weather minor increases or decreases in the pace of Fed rate hikes. Second, there is an underlying recognition that economic fundamentals are relatively stable, and modulation in the Fed's behavior is likely to ultimately ***ensure*** a moderate economic cycle, rather than ***exacerbate*** business-cycle fluctuations. The same is true with regards to the BoJ, ECB, and most other central banks. Against this backdrop of slow central bank adjustment, long-term forward rates in most markets still appear to be at fair levels, if not a bit high, leaving bond markets poised to once again generally outperform cash.

FORWARD RATE CURVES APPEAR FAIR TO SLIGHTLY HIGH (%)

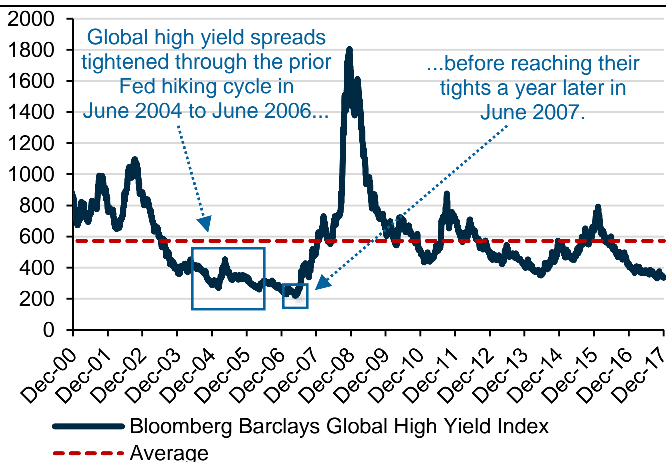


Source: Bloomberg as of January 2018.

Cautious Central Banks Extend Business Cycle and Spread Product Outperformance

Additionally, the cautious and pre-emptive approach of the world's central banks—and the resulting stable economic backdrop—is likely to allow the current economic expansion to continue. In turn, spreads on non-government sectors, such as corporate, structured product, and emerging market debt (which in many cases are already tighter than historical averages) seem likely to remain relatively range bound and possibly even narrow further over the course of the year. In short, yet again, it appears that the spread sectors are poised to outperform, with the higher-yielding sectors likely to post the best returns. Despite the overall placid environment, we expect continued opportunities to add value through issue selection and sector rotation as well as term structure and foreign currency management, as discussed in the Sector Outlooks that follow.

BASED ON THE PRIOR HIKING CYCLE, THE FED MAY POSE LESS OF A THREAT TO SPREAD MARKETS THAN GENERALLY FEARED

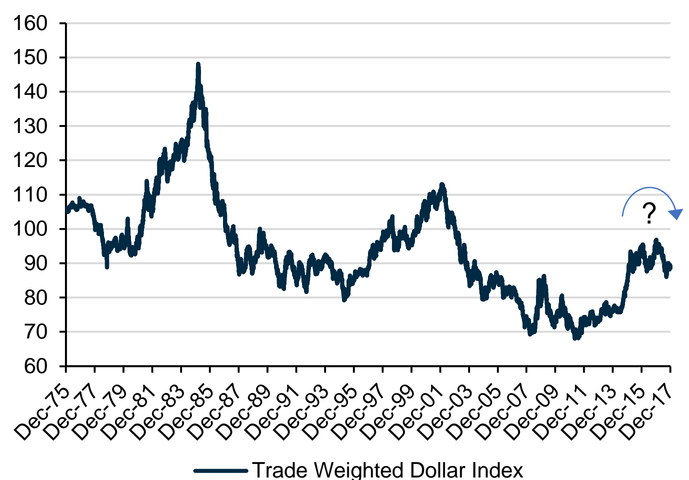


Source: Bloomberg as of December 2017

Dollar Bear Market to Gain Momentum?

In terms of support for the U.S. dollar, the supportive duo of accelerating Fed rate hikes and pending fiscal stimulus have likely passed their peak impact. Dollar negatives may now move to the fore, with the U.S. twin deficit imbalances presumably increasing over the course of 2018 as a result of tax reform. By contrast, currency fundamentals away from the U.S. may improve as other countries experience ongoing rebounds in economic growth and improving fiscal balances thanks, in some cases, to cyclical and structural adjustments.

ON THE VERGE OF A WEAKER DOLLAR TREND?



Source: Bloomberg as of December 2017.

Still the Sweet Spot?

True, rates aren't as high as we may be used to seeing, spreads are tighter than average, and the business cycle is more advanced—all of which point toward a less favorable risk/reward balance relative to years past. But the economic backdrop remains moderate, suggesting that the cycle of stable long-term rates and stable to narrower credit spreads can continue, allowing bonds in the major markets to continue outperforming cash. Additionally, as the global economic cycle catches up with the U.S., currency market trends may continue to shift from dollar outperformance to dollar underperformance, allowing foreign developed and emerging market currencies and bonds to outperform.

The Bottom Line: A moderate economic backdrop maintains viable fixed income conditions even as the major central banks continue to back out of their accommodative postures.

Four Developments in 2018 and Beyond

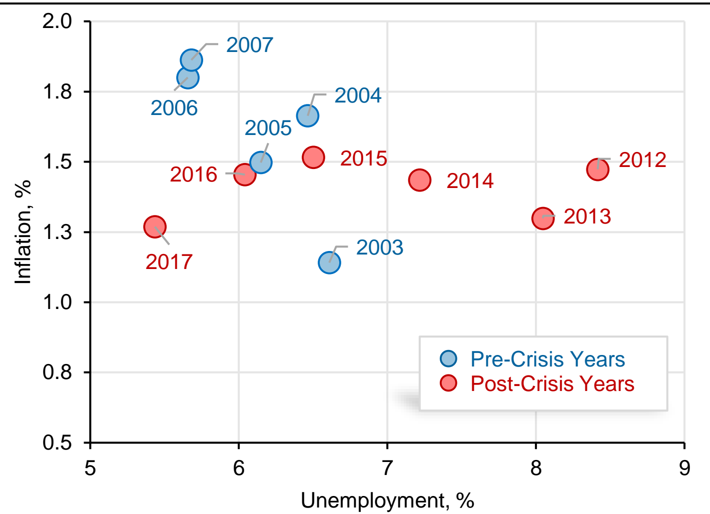
As the new year begins, the global economy continues its impressive performance. With ongoing support from stimulative monetary and financial conditions, aggregate real GDP growth has picked up steam since mid-2016, and the expansion has broadened to include all major advanced and emerging-market economies. These developments have, in turn, helped amplify favorable and self-reinforcing dynamics for global trade, employment, and investment. At the same time, inflationary pressures have remained surprisingly subdued.

In terms of specific geographies, the euro area's performance was a major upside surprise over the past year, with growth there firming to over 2¼%, a full percentage point above its estimated potential rate. The Japanese economy also surprised on the upside, while China and the United States put in strong performances as well. In Russia, Brazil, and Argentina, growth swung from contraction in 2016 to expansion over the past year. Given the breadth of this performance, we judge that the global economy is beginning the new year with a fair amount of momentum.

In our view, the durability of the global expansion will ultimately be determined by the evolution of four underlying economic developments: **1)** the responsiveness of inflation to diminishing resource slack; **2)** the durability of the recent pick-up in global investment; **3)** the pace of central bank efforts to remove monetary accommodation; and **4)** the vigor of Chinese "deleveraging" efforts. In each case, we expect that the economic and policy forces that are in play will support, or at least not disrupt, the ongoing expansion. The remainder of this section examines each of these issues in turn and highlights some accompanying upside and downside risks for the global economy.

How fast will inflation rise? Unemployment rates have fallen to low levels in many countries, notably including the United States, Germany, Japan, and the United Kingdom. Nevertheless, inflation has remained subdued. Figure 1, which displays unemployment and core inflation in the advanced economies, highlights this point. In the years before the global financial crisis (the blue dots), inflation generally trended up as the unemployment rate declined. In contrast, following the crisis (the red dots), inflation has been comparatively unresponsive as unemployment has dropped sharply. This year will shed further light on this relationship. With tightening labor markets, we expect that inflation will pick up gradually during the year ahead. However, the recent behavior of inflation has been difficult to forecast, and we may yet be surprised in either direction.

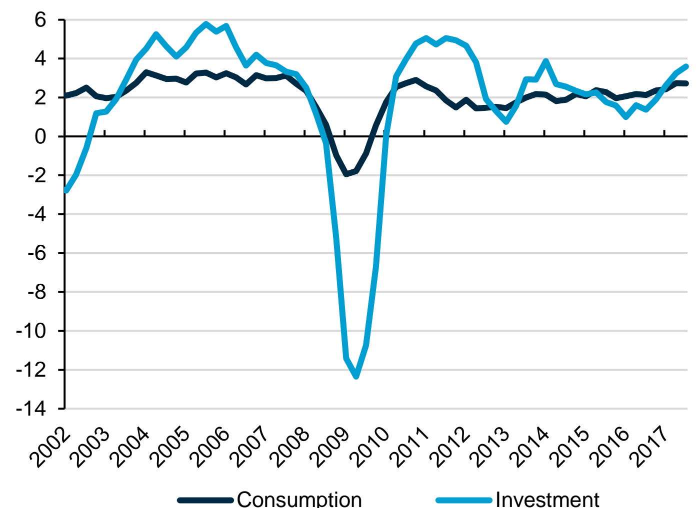
FIGURE 1: ADVANCED ECONOMY CORE INFLATION AND UNEMPLOYMENT



Source: Haver Analytics and PGIM Fixed Income as of December 2017.

Will stronger investment be sustained? Over the last few quarters, global investment has accelerated (Figure 2). This favorable development has supported international trade and added a second demand-side engine for global growth. Our sense is that this strengthening in investment still has room to run. If sustained, it will help lift global productivity growth. Rising productivity, in turn, would allow wages to move up without putting pressure on unit labor costs, thus keeping a lid on inflation.

FIGURE 2: GLOBAL CONSUMPTION AND INVESTMENT GROWTH (Y/Y, %)

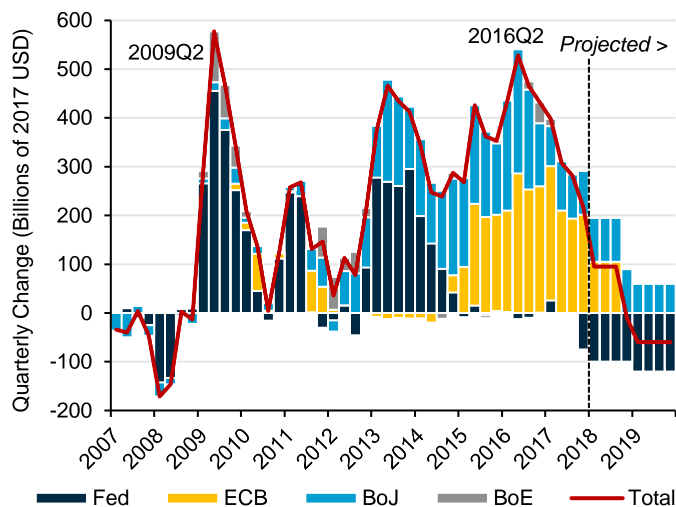


Source: Haver Analytics and PGIM Fixed Income as of December 2017.

How quickly will extraordinary monetary accommodation be rolled back? Our assessment is that central banks will continue to take gradual steps toward policy normalization in 2018. The Fed will remain in the lead, with further rate hikes and balance-sheet paring. But the BoE is also likely to hike at least once next year, and the ECB will conclude its asset purchase program.

The BoJ is expected to continue with its stimulus campaign, but to also reassess its mix of tools. Our baseline is that these actions will be incremental and well-telegraphed and that the overall stance of monetary policy will remain accommodative, albeit less so than in the past. Nevertheless, as highlighted in Figure 3, aggregate central bank asset purchases are now on a downward trajectory and are slated to turn negative in 2019. As such, there are risks that markets may react more adversely to the unwinding of purchases than we now expect, or that the favorable global environment will prompt central banks to accelerate the pace of normalization.

FIGURE 3: CENTRAL BANK NET ASSET PURCHASES



Source: Federal Reserve, Bank of Japan, European Central Bank, Bank of England, and Haver Analytics as of December 2018.

How worrisome is Chinese "deleveraging"? The Chinese authorities have expressed concern about the extent of credit and leverage in their economy and have taken some early steps after the 19th Party Congress to address financial excesses, especially banks' off-balance sheet activities. Our expectation is that real GDP growth in China will moderate in 2018, but will not slow sharply. The authorities are intent on achieving financial rebalancing, but not at the expense of near-term stability. As such, we see this slowdown in Chinese growth as a benign development, especially considering the higher investment demand and strengthening recoveries elsewhere in the world, and as one factor attenuating global overheating concerns. Nevertheless, there are risks around this assessment. For example, given China's role as an engine of global growth, even a relatively modest decline in Chinese growth may impede activity elsewhere through trade and commodity price channels. Alternatively, these efforts to rein in credit and leverage may prove inadequate, and imbalances in China may continue to build. Such an outcome would mean higher growth during the coming year, but would pave the way for imbalances down the road.

In addition to these four factors, there are others that may leave their imprint on economic performance. This year brings elections in major economies including Italy, Mexico, Brazil, Russia, and the United States. As a related issue, with the Trump Administration viewing the benefits of international trade more skeptically than its predecessors, key U.S. trading relationships—including those with China, Mexico, Canada, and South Korea—risk increased tensions and disruption. We are also monitoring the effects of the recently approved U.S. tax bill on the U.S. and global economies (click here for some global perspective on the tax package). Finally, geopolitical uncertainties remain in play. Developments in North Korea, the Middle East, and Venezuela will continue to pepper the headlines through 2018.

Even as we remain optimistic about the overall outlook for the next year or two, we also note some lingering longer-term challenges, especially for the advanced economies. Perhaps the most foreboding of these is the well-documented deterioration in demographics. Adverse demographics will both shrink the tax base and boost demand for government spending on pensions and healthcare. The United States, in particular, has not taken sufficient pre-emptive actions. Another salient challenge is that productivity growth has disappointed through the current cycle. This slowdown in productivity, if extrapolated forward, means lower standards of living and less capacity and flexibility to respond to economic shocks. Finally, while we don't see a global recession on the horizon, history teaches that recessions eventually come. Our sense is that the global economy and financial system are stronger than they were a decade ago. But periods of favorable economic and financial performance, such as our current backdrop, typically hold the seeds of future downturns. For this reason, we continue to watch vigilantly for any hints of vulnerability.

The remainder of this essay considers the economic performance of major global regions in more detail.

United States

U.S. economic growth has accelerated from 1.5% in 2016 to an estimated 2.3% in 2017. Given the positive momentum and approval of the tax package, we modestly raised our 2018 U.S. real GDP growth forecast to 2.7%. Encouragingly, the source of growth has rotated somewhat toward stronger business investment—a trend the tax package is likely to foster further in 2018. A rebound in corporate profits, weakening dollar in 2017, and broad-based, synchronized growth among U.S. trading partners have contributed to this improvement. Strong consumer spending, meanwhile, has been supported by a drop in the household saving rate over the past two years and a modest pick-up in borrowing. Proposed tax cuts for an estimated 60% of households are expected to continue supporting robust consumption in 2018.

While the sweeping tax reform should be a net positive for the economy, there will be winners and losers that standout. An estimated two-thirds of the tax cuts over the next 10 years will accrue to corporations and small businesses. And while we expect the tax package to encourage more business activity, at least some of the savings may be passed on to shareholders and other business owners. On the household side, new limits on state and local tax write-offs could impact consumer spending and residential real estate in high-tax states. And for both companies and households, the measures marginally discourage borrowing by limiting the deductibility of interest payments. The Joint Committee on Taxation estimates the tax package will likely raise the federal deficit by $1 trillion over the next 10 years—even after accounting for the expected boost to economic growth. Despite the solid economic backdrop, core inflation continues to undershoot the Fed's 2% target, with decelerating or declining prices spread across sectors in 2017. Meanwhile, wage growth

remains stuck around 2.5%. While we anticipate inflation will likely firm a bit as 2018 progresses, we still expect inflation pressures to remain capped overall. In its December 2017 projections, the Fed raised its median 2018 GDP growth projection to 2.5% and lowered its 2018 median unemployment rate to 3.9%—partly on expectations of the tax package—but left its median 2018 inflation projection unchanged at 1.9%. Similarly, the median projection for rate hikes was also unchanged over the next two years, anticipating three additional 25 bp hikes in 2018, followed by two more in 2019. We broadly concur with the Fed's economic assessment for 2018, and now expect 3-4 rate hikes in 2018. In her final press conference as Fed Chair, Janet Yellen observed that the financial system is now stronger and likely more resilient to shocks than it was a decade ago.

Euro Area

The recovery in the euro area (EA) is proving surprisingly resilient and will likely extend beyond 2018. We see real GDP growth slowing slightly next year, from 2.3% last year to 2.1% in 2018, as resource slack begins to narrow and the ECB winds down its asset purchase program. Even so, the near-term risks are skewed to the upside amidst unusual buoyancy in conjunctural indicators; for example, the German IFO business sentiment index reached a new, all-time high in late 2017. A substantial decline in the dispersion of growth across the 19 EA economies also indicates the breadth of the recovery. The European Commission expects that the stance of fiscal policy across the region will be broadly neutral next year, with a structural budget deficit (i.e., adjusted for the economic cycle) at just over 1% of GDP.

As in other advanced economies, inflation dynamics remain subdued. The EA unemployment rate has declined, but it remains 1½ percentage points above its pre-crisis low. Combined with subdued productivity growth and a structural shift of employment to services, wage pressures have so far remained lackluster. Given these developments, headline inflation likely averaged 1.5% in 2017 and is expected to remain broadly unchanged in 2018, largely owing to base effects. That said, inflation risks now point to the upside, especially in Germany where unemployment has fallen to post-unification lows. Against this backdrop, monetary policy accommodation is being scaled back. Beginning in January, the ECB is halving its monthly asset purchases to €30 billion. The central bank will decide in the coming months whether to halt its purchases in September, which is the most probable outcome in our view, or to extend the program one last time. The ECB will also consider adjustments to its forward guidance. By mid-year, we see the Governing Council softening its commitment to leave policy rates at their present levels if the recovery continues. This move would be seen as a signal that normalization of policy rates will begin sooner than markets expect. Furthermore, in early 2018, a decision on the successor to Vítor Constâncio, the ECB's Vice President, may also trigger a "package deal" agreement on the successor to Mario Draghi, whose term expires in October 2019.

Japan

Strong economic momentum has taken hold in Japan over the last year, amidst signs some of Abe's reform policies are bearing fruit. Japan's estimated potential real GDP growth rate has doubled over the past few years to about 1%, driven by increased labor force participation among women and older workers and a pickup in productivity growth. Actual GDP growth, expected to be 1.6% in 2017 and 1.4% (with upside risks) in 2018, is exceeding even this higher estimate of potential. Sources of the recent growth have been broad, with a pickup in business investment, consumer spending, and net exports all contributing over the past year. Expenditures related to the 2020 Olympics should also contribute to 2018 growth. Notwithstanding the strong economic performance, core inflation is currently around 0% and is expected to rise only marginally in 2018.

With its policies gaining traction, the BoJ is expected to continue its current policy of QQE with yield curve control that anchors the short-term policy rate at -0.1% and the 10-year JGB yield at around zero. At some point in 2018, however, the BoJ is expected to reassess its mix of policy tools, perhaps after spring wage negotiations in the private sector are completed and bank earnings results are available. The BoJ could possibly target a slightly steeper yield curve at that point, perhaps by modestly raising its 10-year JGB yield target. Such action could support bank profitability and thus loan growth to the private sector, helping to reinforce reflation pressures.

Emerging Markets

Emerging and frontier markets generally performed well in 2017, taking advantage of the broad-based world economic expansion and favorable commodity prices. This backdrop set the stage for relatively benign inflation dynamics as well as narrower fiscal and external balances. These positive economic fundamental trends were reflected in strong performance of EM assets—even against the background of gradual moves toward monetary policy normalization in advanced economies. However, some important differentiation emerged, especially toward the end of 2017, with "low-yielding" EM Europe and Asia generally outperforming, while idiosyncratic factors weighed on bellwethers like Turkey, South Africa, and Mexico. One key ingredient in this mix has been that the broad, but not spectacular, expansion in global growth has only gradually narrowed output gaps. As a result, inflation did not surprise on the upside, commodity prices were well behaved, and policymakers kept financial conditions easy, thus enabling capital flows to EM to hold up, while trade and investment staged a rebound. While our baseline is for these favorable trends to remain intact, we'll continue to monitor how the previously stated developments in China could affect the outcome.

In Latin America, the growth momentum and improving inflation dynamics are expected to extend well into 2018, notwithstanding latent external risks and the continued need to address macroeconomic imbalances. The budding economic recoveries in Argentina and Brazil will likely drive accelerating growth in the region, while inflation rates across the main inflation-targeting economies should generally continue to march toward their targets. With elections scheduled for later this year, the political environment will heat up in Mexico, Brazil, Colombia, and Peru. Finally, we see Venezuela's economic and political crisis remaining largely contained, but it is a situation that we continue to watch closely.

Tax Reform Impact by Sector

- The lower corporate tax rate combined with the ability to immediately expense capex should provide a material boost to earnings and funds from operations for the largest **telecom and cable** companies.
- **High yield cable** companies have very high capital expenditures and high debt loads, but interest expense is generally less than 30% of EBITDA. The companies typically have large net-operating loss (NOL) carryforwards, but many are rolling off, and new tax rates will be lower and they will also benefit from the full depreciation of capex.
- Many of the **media** names will also benefit from the ability to expense 100% of the cost of domestic film, television and theatrical projects at the time of a release.
- Within **technology**, the biggest impact of tax reform will be movement to a territorial tax system and the deemed repatriation of billions of dollars in offshore cash and foreign earnings. While we expect this will result in reduced future debt issuance and potentially the redemption of short-term debt, an acceleration in dividends and/or share repurchases is also likely.
- For **high yield technology** credits, the tax law change is a net neutral depending on sub-sector (modest negative for highly levered software credits, a sub-sector with high LBO activity).
- **U.S. banks'** retained earnings capacity and profitability metrics (ROA/ROE) should improve. Shareholders will likely benefit through higher capital payouts in the form of dividends and share buybacks under the current Comprehensive Capital Analysis and Review framework. The lower tax burden should provide greater protection to capital in the event of a credit downturn. The lower tax rate will also lead to writedowns of Deferred Tax Assets (DTAs) incurred during the financial crisis.
- Higher after-tax consumer income could support valuations for consumer **credit card companies**. The reduction in the SALT deduction could impact credit demand and borrower creditworthiness, particularly regarding mortgage exposures.
- Changes to interest deductibility could reduce loan demand, with some companies possibly opting for leases for some capital purchases, for example.
- In terms of the capital markets, the lower corporate tax rate should support equity valuations and the IPO market. The debt capital markets could see less high yield issuance.
- For non-U.S. domiciled **insurers** (mainly Bermuda based), the reform appears to be removing most, but not all, of the previous tax benefits from their domiciled locations. In the near term, the tax reform impact appears constrained to an earnings event, possibly benefitting shareholders. These payouts may be balanced against the less clear impact on book value since insurance remains capital intensive. Write-downs of DTAs may well be sizable for some insurers, but should be a manageable event from credit perspective.
- The benefit of the tax rate cut appears partly offset by fewer and smaller deductions that may raise **life insurers'** cash taxes and may formulaically cut into some of the currently strong regulatory capital ratios. The less clear GAAP book value impact is driven by the fewer and smaller deductions that affect balance sheet items (policy reserves, deferred costs, and deferred taxes).
- The benefits of the lower tax rate appear partly offset by changes to the treatment of claim reserves and tax-deferred income, which are significant drivers of taxable income for non-life insurers. The Base Erosion and Anti-Abuse Tax (BEAT) part of the tax reform appears to be a neutral to slight negative for the non-U.S. or foreign domiciled reinsurers. BEAT appears likely to raise these tax rates closer to the newly reduced U.S. tax rate.
- The bill allows for individual investors in **energy MLPs** to apply a deduction for pass through income generated from the MLP against their tax basis and then lowers the top individual rate, thus preserving MLPs' tax advantage, although it does narrow the gap from about 8.4% to 6.4%. The implication for credit is that the equities and the cost of equity capital for MLPs should start to recover due to the tax advantages relative to a C-corp investment. A lower cost of equity capital would hopefully incentivize midstream companies to lean less on the balance sheet and improve credit quality.
- **Refiners** will benefit from the lower corporate tax rate as will shareholders given that refiners' balance sheets are already solid and capital expansion opportunities are fairly limited. For upstream independents, the expansion of bonus depreciation will theoretically lower their tax bills since their depreciation is usually tied to the production generated by the wells they operated (which deplete over a period of years). However, the bonus depreciation effect will probably be limited because many of these companies, as well as the **integrated majors**, have significant loss carry forwards from the 2016 oil bust. Repatriated cash could be deployed into U.S. shale drilling, lowering the need for debt financing, which would be credit positive.
- The lower corporate rate may only be a marginal positive for **pharmaceuticals**, and measures to limit base erosion may be negative for some (such as those that have done tax inversions). Firms with large operations in Puerto Rico could be affected by a tax imposed on intellectual property held in Puerto Rico, which could be a negative.
- The bill reduces the Orphan Drug tax credit from 50% to 25% of qualified expenses, a possible marginal negative for companies focused on such therapeutic areas.
- Gaining access to cash "trapped" overseas could be a big credit positive given the reduced pressure to borrow to fund shareholder returns and M&A. Access to foreign cash flows will also make it easier for companies to reduce debt following leveraging M&A transactions, which would be a positive. However, to the extent that tax reform unleashes pent up demand for healthcare M&A, it could be a short-term negative.
- Competition among **health insurers** may result in companies lowering premiums charged to customers, which could limit the tax savings. Savings are also limited by the ACA-mandated "medical loss ratio," which requires a certain level of premiums (less taxes) to be spent on medical care. Individual mandate repeal in 2019 will result in fewer people signing up on ACA exchanges. Fewer healthy participants will

likely increase premiums. However, most of the health insurance credits we cover have already withdrawn from the exchanges.

- The change in net interest deductibility will be a negative for **high yield healthcare** credits. The individual mandate repeal will be an incremental headwind for Hospitals. PAYGO sequestration cuts (4% cut to Medicare reimbursement), if triggered, would be an incremental headwind for credits with higher Medicare reimbursement concentration.
- **Retailers** paid an average tax rate of 30.6% in 2016, according to PWC, and most investment grade credits will meaningfully benefit from tax reform. Retailers will also benefit from the ability to immediately expense qualified improvements to property.
- The potential for negative impact to the housing sector, and by extension to **home improvement retailers,** appears limited as one recently noted that only 5% of mortgages are over $500,000.
- If a U.S. retailer uses a sourcing company in Asia and is paying fees to that party for procuring goods, negotiating pricing, or coming up with qualified suppliers, etc., those types of sourcing fees could fall under the BEAT tax, for example. The BEAT tax is 5% in 2018, 10% in 2019 and 12.5% after 2025.
- The effect of the reduction in the SALT deduction will be something to watch for retailers that have a higher proportion of their footprint in high-tax states. The heightened retail competition may mitigate some of the tax savings elsewhere.
- Increased discretionary spending could drive top-line growth at certain **high yield restaurant** chains.
- There are a few **high yield consumer product** firms with interest expense that is substantially greater than 30% of EBITDA with minimal capex to offset the difference, thus EBITDA may decline.
- **Food and beverage** firms may benefit from the ability to immediately write down the cost of equipment purchases. The tax bill also includes a two-year provision that would cut federal excise tax on alcohol makers. Multi-nationals will need to pay taxes on offshore earnings at the new 15.5% rate for cash and 8% on other.
- A large portion of offshore cash may be used to pay down short-term debt as some companies issued debt to finance dividends, interest, and stock buybacks.
- Multi-nationals that hold intellectual property, trademarks, and patents offshore could be taxed on excess income generated from these intangibles under the global intangible low-taxed income (GILTI) tax provision.
- Regulated **utility** operators will eventually pass much of their tax savings on to customers, while unregulated operations will benefit from the cut. Holding companies will realize a lower tax shield on parent interest expense. Issuers with significant unregulated operations will benefit, while issuers with a lot of parent debt are likely to see a negative impact. Interest expense at the regulated operations is exempted from the deduction limits. At the holding company level, we see only modest effect on the more levered issuers and no effect on less levered issuers.
- Most of the large **high yield independent power producers** have significant NOLs, shielding them from significant tax liability for many years. We understand the full use of NOLs is also being limited so we will be looking for additional color from management teams on the impact.
- There are interest deductibility carve outs for utility companies that are regulated by a commission. There is some debate about if **merchant power companies** fall under that definition as they are regulated by the FERC. We believe this to be a long shot, as the rules will be clarified to include a commission that has authority to regulate a rate of return for the company, which is not applicable to independent power producers.
- Reduction in personal income taxes could stimulate retail **auto** demand, while lower corporate tax rates and favorable depreciation could boost spending on fleet vehicles. Also, 100% of capex expensing for businesses could provide an additional boost, particularly for pickups.
- For **high yield equipment-rental** names, the interest deductibility provision is a potential negative amid the absence of a like-kind exchange provision allowing an avoidance of tax on sales if the cash went to new equipment.
- Relatively high **rail** capex will also continue to benefit from the bonus depreciation.
- The increase in the budget deficit could be a potential offset for **aerospace/defense** firms if it curtails growth in military spending. More highly leveraged companies that don't have large capex could feel some pressure. **Airline carriers** are not generally Federal taxpayers currently due to large NOL carryforwards from previously incurred industry losses. Airlines also benefit from the ability to fully deduct capital spending.
- **Industrial manufacturers** should benefit from repatriating foreign profits. If tax reform boosts the economy and results in higher discretionary income, we believe this could be used by individuals reinvesting in repair and remodel projects, which benefits the **building materials** sector.
- Interest deductibility can remain for companies involved in real-estate, and **high yield homebuilders** believe they will qualify. The homebuilding universe has interest expense below the new interest-deductibility thresholds that are being established. Some potential headwinds for the homebuilders include the reduction in the SALT deductions, lower mortgage interest deduction, the adjustment to the shielded capital gains on a home sale.
- Major U.S. **tobacco** companies are among the largest income tax payers in the U.S. and the lower corporate rate should provide a boost to cash flow and earnings. Share buybacks may follow.
- On average only about 15% of revenue in the **paper** industry comes from outside the U.S., and the lower taxes should provide for improved earnings and cash flow. Capex expensing could be a slight benefit for some firms as they convert older paper mills into new containerboard mills.
- Bonus depreciation will benefit **chemical** companies with active construction projects, though the capex cycle is ramping down.

Developed Market Rates

As we examine the drivers within the developed rate markets, we expect the Japanese and European markets will be key drivers for the U.S. term structure.

In Japan, the continuation of QQE and yield curve control will likely keep the 10-year JGB yield in a range of -10 bps to +10 bps through Q1, prompting domestic investors to maintain their global search for yield. While this search has largely been on a currency hedged basis, it is likely to continue to include duration and credit risk, thus putting further downward pressure on global term and credit premiums. We expect the Bank of Japan to remain on hold through Q1, but as the year progresses, there is a possibility that the BoJ raises its yield-curve control target slightly, perhaps with the intention of solidifying its reflation efforts via improved conditions in the banking sector.

In Europe, we believe that the front of the Bund curve will likely underperform. Although the front of the curve rose slightly in Q4 to -61 bps, we continue to regard valuations overly rich even with the ECB likely to hold rates steady throughout 2018. Market expectations of diminished ECB asset purchases, improved access to lending channels, and slightly larger bank balance sheets should contribute to higher EUR rates, especially in Germany. We expect that the two-year rate will move closer to the deposit rate of -40 bps over the course of the year. Higher front-end rates could mark the start of a structural curve flattener along the Bund curve as the 30-year yield is likely to trade around 1.25% or below. We also favor a swap spread curve steepener position in Germany.

The newly passed U.S. tax package will continue to pressure future budget deficits, which will heighten the need for international deficit financing via increased Treasury issuance. This could offset the positive effects of potential regulatory reform and pause the widening in long-dated swap spreads. While the front end of the U.S. swap spreads curve may be affected by increased corporate issuance to start the year, this technical factor should fade shortly, thus we remain constructive on swap spread widener positions along the two- to seven-year segment of the curve.

Elsewhere, we maintain a neutral view on U.S. TIPS and would be buyers of five-year breakevens on a dip early in Q1. For the past eight months, five-year breakevens have generally traded in a range of 1.60%-1.85%, which we expect to remain steady in the near term.

Finally, the UK Gilt market will be driven by Brexit developments, and the Bank of England is likely to proceed cautiously until it gains more clarity. That being said, the BoE's rate path appears far too shallow with less than one hike priced in from mid-2018 through mid-2019, thus UK rates appear biased to move higher overall.

OUTLOOK: Tactically constructive. We'll continue to take our positioning cues from upcoming developments within the JGB, Bund, and Treasury markets. These could include stabilizing intermediate yields in the U.S. and the start of some curve flattening in Europe. The effect from deficit financing in the U.S. will be in focus for the long term.

Agency MBS

While investors' ongoing search for carry provided the MBS sector with a solid excess return versus Treasuries in Q4 and 2017, we expect the headwinds from the Fed's balance sheet roll-off to intensify in 2018 and support our underweight to MBS relative to other high-quality spread sectors.

In Q4 2017, the conventional 3.0% and 3.5% cohorts outperformed as banks bought more than $32 billion MBS during the first two months of the quarter (following their purchase of $55 billion in Q3), and taxable bond fund net inflows totaled more than $52 billion. Investors who underweighted the sector seemingly covered their positions during the quarter, thus adding another source of demand. The short covering became more pronounced when MBS' underperformance relative to investment grade corporates and CMBS reached more than 50 bps.

As was the case for much of 2017, prepayment speeds were contained in Q4 as notional mortgage rates remained rangebound and only rose slightly to an average of 3.83%. With primary mortgage rates remaining relatively sticky, we don't anticipate an increase in prepayments unless primary rates decline by at least 25 bps from current levels.

With the Treasury yield curve flattening, 30-year MBS with higher coupons of 4.0% and greater lagged as investors preferred lower coupons with more key rate duration in the long-end of the curve. Ginnie Maes underperformed during the quarter as GNMA (and not the Veterans Administration) announced steps to monitor accelerated prepayments, which the market found underwhelming. Although Ginnie Mae is expected to follow up with additional measures in 2018, the securities are likely to continue underperforming given their poor carry characteristics and growing percentage of net supply.

As we look ahead, we're cognizant that the MBS sector maintains a broad buyer base as long-term rates remain range bound, volatility hovers near historically low levels, and investors continue their search for spread. For many of these buyers, the sector presents an attractive degree of duration-adjusted carry amid a flatter yield curve. As 2017 concluded, the sector easily handled a modest amount of year-end selling, some of which emanated from accounts based in Japan. Given the winter seasonal of relatively low origination levels, mortgages should continue to be supported into early Q1.

Still, the Fed's balance sheet roll-off will be a prominent factor within the sector. In Q1, the Fed is likely to only reinvest $15 billion during the January/February cycle, down from the $20 billion reinvested during the December/January cycle. While the tax bill affects some of the incentives regarding home ownership, the impact could be mitigated by increasing housing demand—thus an increase in origination—if economic growth accelerates due to the tax reform. Net supply in 2017 totaled about $300 billion and estimates place 2018's total at a similar level.

In addition, with tight nominal and option-adjusted spreads, an increase in volatility could prompt some notable spread widening, and demand could also fade as rising floating-rate securities approach the same yield as 30-year MBS.

Our positioning reflects expectations for mortgage spreads to widen in Q1. We continue to underweight the sector relative to other high-quality spread sectors, but will look to transition the underweight vs. Treasuries as net supply outpaces net demand. We're monitoring the effect from the Fed's balance sheet contraction—which may become more visible in Q2—particularly in the context of the sector's tight spreads and low volatility. Within the coupon stack, we prefer 30-year 3.5% issues and would look to 3.0% issues if the U.S. yield curve flattens notably, or 4.0% issues if the curve flattening trend abates. Elsewhere, we remain underweight 15-year issues and GNMA 2s.

OUTLOOK: Underweight in favor of high-quality spread sectors and rates, respectively. We prefer 3.5% issues for better carry opportunities and remain underweight 15-year and GNMA 2 issues.

Structured Products

Structured products performed strongly in Q4, and for all of 2017. Spreads tightened across all sectors with legacy non-agency RMBS tighter by 10 bps for the quarter and 70 bps for the year, AAA CMBS tighter by 10 bps and 28 bps, and AAA CLOs tighter by 12 bps and 34 bps for the quarter and year, respectively. We believe there is further upside in AAA CMBS and CLOs in Q1, as current spreads still offer value compared to other fixed income sectors. Non-agency RMBS are, however, more fully valued, and we suspect these bonds will likely only earn their carry going forward. Our favorite sectors continue to be AAA CLOs and CMBS, and we continue advocating other senior financing trades.

Non-Agency RMBS: We expect residential housing markets to remain strong in 2018 and 2019 as low interest rates, millennial household formation, expanding credit availability, and solid economic growth provide an excellent backdrop for U.S. housing. We expect home price appreciation to be a solid mid-single digit percentage increase in 2018. While we generally do not think tax reform will pressure most home values due to the increase in the standard deduction, higher value homes in states with high state and local taxes (SALT) could come under pressure as the increase in the standard deduction will not offset the loss of SALT deductions. For legacy U.S. RMBS bonds, technicals remain overwhelmingly favorable with the legacy non-agency float declining 10-15% on an annual basis; nevertheless, we find these bonds to be increasingly fully valued and with prices now well in to the ~90 dollar price area, the credit convexity of these cashflows has deteriorated. Senior bonds issued in 2006/07 are now trading at loss-adjusted spreads of LIBOR+125-150 bps, with upside/downside risks from actual mortgage losses deviating from pricing expectations appearing more symmetric. Credit risk transfer bonds from Fannie and Freddie also appear fully valued, with M2 tranches now trading at L+190 bps, tighter by 170 bps on the year. We favor financing RMBS assets rather than owning the underlying outright, with our favorite expressions being RPL, NPL and re-securitizations of legacy bonds. Away from the U.S., we are neutral on senior UK RMBS non-conforming paper with generic spreads currently L+70-80 bps. Potential headwinds are a cooling UK housing market, consumer affordability concerns, and Brexit-related uncertainty.

CMBS: On an aggregate basis, commercial real estate (CRE) prices have eclipsed the 2007 peak for some time now, but the recovery across submarkets and property types has been uneven. We expect pockets of weakness to continue with retail and suburban offices particularly out of favor. We are also wary of hospitality in potentially oversupplied submarkets (NYC) and in the event of a broader economic slowdown. Nevertheless, we believe the headlines on CRE are excessively alarmist as cap rate spreads remain at, or slightly above, their long-term average, which provides a cushion should rates rise, and pending tax law changes are particularly favorable to CRE (e.g., preservation of interest deductibility and 1031 like-kind exchanges and new favorable treatment of pass-through income). We continue to favor front-pay 10-year tranches off conduit securitizations, interest-only tranches and select mezzanines off single-asset/single-borrower (SASB) transactions with favorable underlying CRE fundamentals. We are not constructive on conduit mezzanine tranches as underwriting quality is unimpressive and structural support is lacking, but acknowledge that the reach for yield could still propel spreads tighter and the credit curve flatter in 2018. CMBS AAA spreads followed broader markets tighter during the quarter, reaching tights of Swaps+75 bps before widening to S+82 to end the year. AAA spreads had started the quarter at S+92. Assuming macro volatility remains low, we expect 2018 issuance to be 20% lower than 2017—in the range of $70-$75 billion for private label CMBS—with conduit issuance of $40-$45 billion and SASB issuance of $25-$30 billion. Although CMBS demand has been spotty post-crisis, we do not expect supply to weigh on spreads this year. Negative retail headlines continue to be a large focus in the market. Mezzanine tranches from deals originated in 2012 and 2013, as well as CMBX from those vintages, reached new wides once again in Q4. These vintages have large concentrations in class B/C malls. CMBX6 BBB- was 10 bps wider and CMBX 7 BBB- was 15 bps wider in Q4. The senior-most tranches have been immune from the mezzanine volatility.

CLOs: Our leveraged finance team believes that corporate balance sheets remain broadly healthy, and we expect a benign default outlook for 2018 globally. Within senior secured loans, increasing leverage, more aggressive add-backs and the loosening of covenants may result in recoveries that will be below historical averages. That said, we continue to overweight AAA & AA CLOs given their attractiveness on a relative and absolute value basis versus other fixed income sectors. Further, we anticipate that a flatter yield curve will continue to attract investors into floating-rate products and provide a further catalyst for spread compression and elevated issuance in 2018. On a new issue basis, AAA U.S. CLOs currently price between 3L+107-121 bps. European AAAs price around 3mEuribor+73 bps, but net of the value of the zero Euribor floor (which we believe is worth about 12 bps) and the value of the Euro/Dollar currency swap (35 bps), we see them as roughly fair relative to U.S. CLOs. Issuance in 2017 has surprised to the upside as equity demand from risk retention capital providers and yield seekers coincided with demand for senior bonds from asset managers, insurance companies, and bank CIO offices. The 2017 U.S. new issues numbers are $114 billion in primary, $102 billion in refinancings, and $62 billion in resets.

ABS: Consumer balance sheets have improved since the financial crisis on the back of strong employment, moderate wage gains, and widespread debt forgiveness. Nevertheless, the marginal borrower in unsecured and secured ABS is still, almost by definition, stretched financially. We favor unsecured consumer loan and subprime auto ABS across the capital structure from originators with strong legal and compliance procedures and a bias toward cashflow underwriting models. We remain cautious with online marketplace lenders due to unproven and shifting business strategies and regulatory ambiguity. Demand for ABS has been very strong across the entire capital stack and spreads in most sectors remain at or near 2017 tights. Gross new issuance for 2017 was $220 billion, the highest total since the credit crisis and 18% ahead of 2016's pace.

Other: Although regulatory pressures are decreasing, traditional financial intermediaries remain constrained with respect to capital, balance sheet, or both. We continue to look for opportunities to provide financing solutions in situations where we feel confident in our ability to value the underlying collateral, confident in the issuer's legal and compliance ethos, and believe the financing structures adequately protect our interests as senior or mezzanine lenders.

OUTLOOK: We remain very positive on top-of-the-capital structure issues, especially CMBS and CLOs. For legacy RMBS, we would be content to earn carry at current spread levels. We are negative on conduit CMBS mezzanine tranches as conduit credit quality is unimpressive. We are increasingly looking at financing trades rather than exposure to the underlying assets as spreads on the underlying assets are tight and the demand for leverage is high.

U.S. and European Corporate Bonds

U.S. corporate bonds closed the year on a positive note, supported by tailwinds from the new U.S. tax reform act, ongoing investor demand, robust earnings, and positive global economic growth. For the year, U.S. corporate spreads narrowed by -30 bps and posted an excess return of 345 bps over similar-maturity U.S Treasuries.

Despite some volatility, European corporate bonds also delivered a positive return in 2017 as spreads exceeded expectations by narrowing 37 bps during the year. Key support factors continue to be the ECB's corporate bond buying program and stronger-than-expected economic momentum, dynamics which should continue to insulate the broader market from issue-specific headline events going forward.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q4	2017	Q4	2017	12/31/2017
U.S. Corps.	1.17	6.42	-8	-30	93
European Corps	0.64	2.41	-10	-37	86

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

U.S. Corporate Bonds

Despite the Federal Reserve's well-telegraphed plan to raise short-term rates, current accommodative global monetary policies still support U.S. corporate bonds. We remain optimistic that spreads will grind modestly tighter against a backdrop of strong investor demand, healthy fundamentals (supported by global growth, strong earnings, and a weaker USD), and optimism surrounding tax reform.

We look for lower corporate tax rates to provide a boost to the market, although other aspects of the tax plan may stoke volatility across the credit curve. The repatriation of up to $2 trillion of offshore profits, for example, should lead to reduced issuance from multinational companies, particularly in the technology and pharmaceutical sectors, and selling in short-maturity (1–5 year) spread product. This could result in a flattening of the spread curve with the front end widening while the back of the curve remains in demand from overseas investors and pension plan sponsors as they become more fully funded. Limiting the deductibility of interest expense should have little effect on the investment grade market, but may steer companies to favor equity financing over borrowing on the margin.

With non-U.S. developed country rates anchored at ultra-low levels, demand from overseas buyers remains a key driver in the market. Although 2017 U.S. issuance should hit a record, driven in part by debt-financed, shareholder-friendly activities and M&A, demand has been equally strong. The M&A new issue pipeline dropped

meaningfully by year end, but will most likely pick up again now that tax reform details have been finalized. Overall, we look for 2018 issuance to remain on pace with 2017 levels.

Another trend we are watching is the increase in the Pension Benefit Guaranty Corporation's premium (to 4%) on the underfunded portions of U.S. corporate pension plans. The increase, along with a potential decline in the corporate tax rate, has incentivized some companies to contribute more to their plans. These additional contributions, coupled with the strength of the stock market, have improved plan funding levels. In turn, this will support long-duration corporates as pension plans rotate their allocations from stocks to bonds.

As we enter the later stage of this extended credit cycle, we continue to favor better-quality financials and electric utilities over industrials that may be subject to event risk. U.S. money center banks are relatively immune to event risk and should remain subject to higher capital requirements even if other post-financial crisis regulations are relaxed. Within industrials, post-event new issues provide select opportunities. The chemical, health insurance, paper, and select pharmaceutical and energy sectors also appear attractive, as do U.S.-centric issuers. We are looking to add select European banks due to stabilizing fundamentals and wider spread levels. We still favor taxable municipal bonds and remain overweight lower-quality bonds in shorter maturities as well as BBB-rated, long-maturity corporates due to a steep spread curve and potential uptick in demand from pension plans.

European Corporate Bonds

Sentiment in the European corporate market remains centered around the ECB's accommodative policies, most notably its corporate bond buying program, which led to significant spread compression in 2017. The ECB's "dovish taper" announcement in October that extended its purchase program to Q3 2018, and affirmed its near-zero rate policy, firmly pushed questions of ECB support well into next year.

On the economic front, European growth (ex-UK) has continued to impress, providing further support for credit fundamentals that are already near their peak. Unlike the U.S., however, corporate management still exhibits a degree of caution. European M&A activity, for example, is considerably lower than the U.S., but is expected to pick up going forward.

With ECB and non-ECB eligible bond spreads compressing sharply in 2017, the search-for-yield continued to year-end 2017, leading certain sectors, such as sub-insurance, corporate hybrids, and bank bonds that started the year with a degree of stress, to outperform. Meanwhile, new issuance is projected to remain high in 2018, on par with 2017, including U.S. companies issuing in the Euro/Sterling/Formosa markets. Net supply may increase, however, requiring an increased focus on active region, sector, and issue selection to generate alpha.

As in 2017, headline political risk may lead to volatility, and opportunities, in the coming year. Whether these events stay contained to issues with direct exposure, as they did with the recent Catalonia referendum, or extend to the broader market, remains to be seen. Other issues to watch include the Italian elections in March 2018, the formation of a German working coalition, ongoing Brexit negotiations, and, later in 2018, a search for ECB President Draghi's successor.

In European portfolios, we remain overweight, but have trimmed risk and are essentially flat spread duration. We remain overweight non-euro and non-ECB eligible issuers where we continue to find select opportunities. We believe there is less value in core European corporates post the dovish taper, and as such are underweight European industrials and utilities with tight spread levels. We are looking to add European banks based on relative value. We still see opportunities in select reverse-yankee issues that are priced at discounts to where they trade in U.S. dollars. We favor U.S. banks, insurance, and non-core REITS.

Within euro-area industrials, we continue to favor regulated companies with solid balance sheets, such as electrical grid and airport operators, although finding attractive opportunities has been increasingly difficult. We find value in certain corporate hybrids from stable, well-rated utility issuers and are avoiding hybrids issued to uplift ratings, including those in the telecom industry.

In global corporate portfolios, we hold a risk overweight but have trimmed some euro exposure in favor of U.S. spreads. We are reducing exposure to companies with potential tail risk, such as Italian corporates that trade through the sovereign and are prime candidates for spread widening. Within the financial sector, we remain overweight U.S. money center banks and insurers. We are focused on BBB-rated issuers and U.S. taxable revenue municipals. We continue to take advantage of price dislocations and yield discrepancies between U.S. and euro bonds of the same and/or similar issuers.

In both the U.S. and Europe, we believe that spreads are slightly through fair levels, but have the potential to grind tighter in Q1 given favorable fundamentals, ongoing investor demand for yield, and small recession risk in the near term. Downside risks include more aggressive than-expected central bank policy changes, regional and global geopolitical risks, and, longer-term, China's high debt burden.

OUTLOOK: Modestly positive given favorable technicals and fundamentals, strong investor demand, and economic growth momentum. Still favor U.S. money center banks. Tax reform could provide further upside.

Global Leveraged Finance

High yield spreads approached post-crisis tights early in Q4, however the injection of volatility resulting from some macro- and sector-specific stories sent spreads notably wider. Nonetheless, the high yield market showed its resiliency and spreads recovered 2/3 of their losses as the asset class ended the year on a positive note.

	Total Return (%)		Spread Change (bps)		OAS/DM (bps)
	Q4	2017	Q4	2017	12/31/2017
U.S. High Yield	0.41	7.48	+7	-59	363
Euro High Yield	0.72	6.79	+23	-85	294
U.S. Leveraged Loans	1.09	4.09	-16	-45	416
Euro Leveraged Loans	0.53	3.72	0	-88	392

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

U.S. Leveraged Finance

U.S. high yield returns were modestly positive in the fourth quarter as the momentum from rising equity and oil prices was almost entirely offset by uncertainty around tax reform, questions surrounding global growth, and rising idiosyncratic risk across several high yield sectors. Despite some waning of investor confidence, which spurred heavy retail outflows, buyers took advantage of the cheaper levels and quickly rejoined the market.

The lowest rated credits continued their outperformance with CCCs returning +0.7% in Q4, doubling the return of BBs and Bs. Year-to-date, CCCs were up 10.6%, outpacing the broad high yield index by more than 300 bps. The top performing sector in Q4 was electric utilities (+2.3%), driven by improving fundamentals and further consolidation within the industry—including Vistra Energy's acquisition of Dynegy. The sector was also the best performer in 2017 with a return of +11.6%.

Supported by OPEC's announcement that production cuts would be extended into 2018, the energy sector enjoyed another quarter of solid performance (after outperforming all other high yield sectors in Q3), returning +2.0% in Q4. Despite the two consecutive quarters of strong returns, the energy sector's performance remained in-line with the broad high yield market in 2017.

Underperforming sectors included the consumer products (-2.8%) and cable (-1.8%), as well as sectors where idiosyncratic risk is increasing—telecom (-2.2%), retail (-1.0%), and healthcare (-0.5%).

Moody's 12-month U.S. speculative grade default rate ended November 2017 at 3.4%, slightly higher than the rate through the end of Q3. Through the first two months of Q4, 16 speculative grade defaults were reported. The oil & gas and retail sectors accounted for 22% and 15% of 2017 default activity, respectively, the most by any high yield sector. Looking ahead, Moody's expects the advertising and printing & publishing sectors to be the biggest contributors to default activity over the next 12 months.

High yield bond funds reported outflows of -$9.5 billion in Q4, which brought the year-to-date net flow total to approximately -$20.3 billion—most of which was driven by active managers. Although volatile at times, ETF flows totaled +$1.5 billion. New issuance increased year-over-year, climbing to $328 billion year-to-date, up from $286 billion in 2016. The energy sector continued to dominate primary market issuance, accounting for 22% of new issue supply in Q4. The financial sector was also a significant source of new issuance, accounting for 13% of activity. Although general issuance exceeded last year's pace, 63% of the issuance has been related to refinancing activity.

The recent passage of the tax reform package in the U.S. is expected to have a broadly positive impact on corporations and the economy. However, the impact is likely to be somewhat different based on the industry and the leverage in a capital structure. Issuers with low leverage, high capital spending, and high current cash tax rates are poised to enjoy the most benefit. Indeed, we expect the CCC-rated portion of the high yield space to face the most potential headwinds due to the elimination of tax deductibility of interest expense above certain thresholds—a characteristic of lower quality, more levered issuers within high yield. However, the tax benefit from lower corporate tax rates (21% vs. 35% previously) and the full deductibility of capital expenditures will offset this in many cases. Longer term, we expect the more levered issuers to seek to reduce debt levels given the reduced tax benefits of carrying high amounts of leverage. As a result, we anticipate more credit-positive M&A and corporate actions to reduce leverage, thereby improving credit quality, particularly in the lowest quality, default-prone portions of the market most affected by the new tax code.

Overall, we remain constructive on U.S. high yield in the near term given improving fundamentals and supportive technicals. However, we are not as bullish in the long term given tight spreads and elevated tail risks. Despite heightened risks in select sectors (e.g. retail, healthcare, and commodities), defaults are expected to remain low. We remain cautious on commodities and auto-related names, while maintaining an overweight to electric power companies and U.S. consumer-related credits. We also continue to see relative value opportunities in select higher yielding, CCC-like issuers, while hedging beta with elevated cash balances and allocations to AAA CLOs.

Our primary concern remains a recession triggered by an unforeseen event, however we expect such a scenario to result in less spread

widening than in previous slowdowns due to the relative caution exhibited by issuers and investors.

Moving to leveraged loans, lower rated loans—although only approximately 5% of the index—continued to outperform, as CCC loans returned +2.9% during the quarter, outpacing Bs and BBs by approximately 175 bps. Like high yield bond funds, loan funds also reported outflows for the quarter, with -$4.0 billion leaving the asset class. The quarterly outflow trimmed the year-to-date net flow total to +$13.5 billion.

New issue volume in the loan market moderated during the second half of the year, with $397 billion of activity—compared to $577 billion during the first half of 2017. Despite the second-half slowdown, the loan market saw record issuance for the year, with a total of $974 billion of activity. We would note, however, that issuance has been dominated by repricings and refinancings, which accounted for 45% and 28% of all activity, respectively. The technology sector was the biggest contributor to the new issue market, representing 17% of volume. In contrast to the high yield market, the energy sector was significantly less active in the new issue loan market—accounting for 2% of activity—as it is a much smaller component of the overall market. While 2017 was a year in which the leveraged loans posted solid total returns, recorded positive net flows, and saw record issuance, deteriorating underwriting standards within the asset class is cause for concern, and leaves us with a less constructive relative value view.

European Leveraged Finance

The European high yield market was firm heading into Q4, however the combination of weak Q3 earnings from select issuers, volatility surrounding the U.S. healthcare and retail sectors, and large volumes of primary and secondary supply sent spreads wider.

The quarter began with positive net flow activity (October was the fourth month of the year to report a net inflow), however a sizable outflow in November, followed by continued negative net flow activity in December brought the Q4 net flow total to approximately €-2.1 billion. While net flows exceeded €-5.0 billion year-to-date, institutional flows were positive given the strength of the technicals in the European high yield market.

With the primary market remaining active throughout Q4, new issue volumes surpassed €93 billion in 2017, a 77% increase compared to 2016. Debut issuers made up approximately 26% of the activity, up from 13% in 2016. Due to the amount of refinancing activity, the size of the European high yield market decreased slightly from €483 billion at the end of 2016.

Moody's default rate ended November at 2.5%, a slight uptick from 2.4% at the end of the Q3. Given expectations for the European economy to continue to grow slowly, issuers opportunistically taking advantage of favorable market conditions to refinance debt, and the lack of a major near-term maturity wall, we expect default rates to remain low over the next 12 months.

Investor demand for European leveraged loans remains strong, supported by elevated levels of managed account loan money, increased CLO formation, robust demand from banks, and expectations for future rate increases.

Loan issuance reached record levels in 2017, totaling €120 billion—a 73% increase compared to 2016. The surge in issuance was driven largely by issuers that refinanced bonds with loans, a trend that is expected to continue in 2018 as companies attempt to fund refinancings, LBOs, and medium-sized acquisitions. Despite the increase in loan supply, the market capably absorbed the supply.

We remain constructive on European high yield given expectations that spreads may continue to tighten modestly from current levels on improving fundamentals, reduced political risk, and a fair macro environment. While Brexit may present an issue to the UK, Europe could be impacted to a lesser extent. The lack of material recession risk in Europe in the near term, as well as expectations that the ECB will remain accommodative for now, further supports our outlook. One caveat is that additional spread tightening and continued demand for leveraged finance products could prompt some aggressive underwriting, warranting a degree of caution.

We remain overweight B-rated issues amid expectations for spread compression—driven by continued ECB support—in the higher-rated buckets that could filter down the risk spectrum. We will look to tactically increase our BB allocation through the primary market, while seeking attractive relative value opportunities between sterling- and euro-denominated bonds. We expect bonds to continue to outperform loans in the near term, with loans outperforming in the long term.

OUTLOOK: Positive in the near term as fundamentals continue to improve and technicals remain supportive. Longer term, we are more cautious on U.S. high yield given tight spreads and elevated tail risks. Our constructive view on European high yield is based on expectations for modest spread tightening, reduced political risk, and a decent macro environment in Europe.

Emerging Market Debt

This past year was one in which emerging market economies benefitted from the global economy's improving momentum and the emerging market debt asset class generated numerous opportunities across the hard currency, local rate, and foreign exchange sectors.

	Total Return (%)		Spread / Yield Change (bps)		OAS (bps) / Yield %
	Q4	2017	Q4	2017	12/31/17
EM Hard Currency	1.16	10.26	-2	-57	285
EM Local (hedged)	0.03	3.68	+15	-65	6.14
EMFX	2.00	11.54	-42	-109	3.54
EM Corporates	0.68	7.96	-3	-47	260

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

On the back of improving fundamentals, such as narrower current account deficits, falling inflation, and growing central bank reserves, we expect that EM growth (ex-China) will accelerate from 3.5% in 2017 to 3.8% in 2018, far exceeding our estimated growth of 2.3% across the developed world.

Although macro risks remain on the horizon—e.g. the ongoing removal of developed market monetary stimulus, led by the Federal Reserve's contracting balance sheet and prospects for three to four rate hikes in 2018—some of these concerns may be remnants of the volatility surrounding 2013's taper tantrum. In fact, during the last sustained Fed hiking cycle between 2004 and 2006, emerging market hard and local currency debt returned 25% and 29%, respectively.

Many idiosyncratic credit stories—Venezuela, Argentina, Brazil, Mexico, Ukraine, and Russia, among others—will continue to make headlines. Yet developments in 2017 again showed that these events can cut two ways, and that the sector's resilience to macro and idiosyncratic events (as observed in the following chart) and the performance of individual country assets continues to differentiate it.

THE DIMINISHING CONTAGION RISK IN EM

Source: J.P. Morgan as of November 9, 2017.

Even though hard currency spreads tightened steadily in 2017, they still remain well wide of 2007's historical tight of 166 bps, when only one-third of the market carried investment grade credit ratings. At today's wider spreads, nearly half of the market carries investment grade ratings. As 2017 concluded, we maintained overweights in higher-yielding sovereigns and quasi-sovereigns with wider spread levels, and we generally expect spreads to be supported by low developed market rates and solid global growth. Our top overweights include Argentina, Brazil, Ukraine, and Mexico. In regard to our Mexico positioning, we will be closely monitoring potential volatility in Mexican assets over the first half of the year as the July presidential election approahces.

We'll also watch developments in Argentina closely to see if it can maintain positive momentum and deliver on fiscal reforms though 2018 and 2019. Argentina's political climate and related improved policy mix of late should continue to boost investment and capital inflows into the country, which will likely approach high single-B to low-BB valuations if the strategy proves successful. We believe it's provincial and euro-denominated bonds currently offer the best value, but are waiting for more pronounced signals from the central bank to add more strategic FX positions.

In terms of Brazil, its economic recovery should become more tangible in 2018, which is also an important election year. The election outcome will partially determine how Brazilian assets perform over the medium term as we get more clarity on its commitment to market-friendly and debt-stabilizing reforms, along with policies to improve investment. Pension and continued micro reforms are among those steps needed to stabilize Brazil's debt dynamics. Spreads on Brazilian sovereign debt look fair relative to other EM BB-rated issuers but the country enjoys relatively low levels of external indebtedness and high FX reserves compared to many of those credits. This should help limit potential downside from current levels. Against this backdrop, select quasi-sovereigns appear attractive, and local bonds are also attractive in nominal and real terms compared to other local EM markets. The Brazilian real could also benefit from a healthy stream of foreign direct investment over the longer term. As Brazil's political cycle heats up next year, bouts of volatility may provide attractive points to add risk.

Elsewhere in hard currency debt, we continue to seek opportunities to add alpha from exposure to select frontier names. The credit profiles of many of these countries, including, but not limited to, Ecuador, Angola, Ghana, Iraq and Mongolia, are improving with many benefitting from IMF programs. Because these issuers are lower rated and higher risk, we prefer 5- to 7-year issues where we believe spreads are attractive. Prices in this segment of the curve also tend to be less volatile, and there is more visibility that debt will be repaid, notwithstanding potential idiosyncratic or broader market concerns.

Turning to local rates, the real yields across a number of countries—Brazil (4.5%), Indonesia (4%), Mexico (3%), and Colombia (2.5%)—remain attractive. Furthermore, on a nominal basis, the opportunities across the local rates market are reflected by yields that were more than 400 bps higher than the five-year U.S. Treasury yield as of late 2017. We'd note that the exception to our favorable real yield outlook would be certain central and eastern European countries, including

Hungary, that carry negative real yields. Our local rates strategy consists of maintaining long duration and curve flattening positions in select yield curves with our top local rate overweights set in Mexico, Brazil, Indonesia, and Malaysia.

The performance of the local rates market will undoubtedly be influenced by EMFX, where we also have a constructive outlook for the coming year. When EMFX hit some volatility in the second half of 2017, we noted that during prior selloffs that occurred under similar market conditions—relatively strong global growth and tightening Fed policy—the market declined by a maximum of only 5% during those spans. The most recent EMFX selloff, which began in mid-September 2017, represented a 5% decline, and the correction began to reverse course as of mid-November. With that backdrop, we recently added to EMFX risk based on strong growth and relatively low inflation rates. Our top EMFX overweights going into 2018 include the Indian rupee, Indonesian rupiah, and the Brazilian real, though we are keeping our eyes open to more tactical positioning in this segment over the first half of the year.

Loco for EM Local Debt and FX

Despite posting solid total returns and generally outperforming most other major credit indices between January 2016 through the end of Q3 2017, investors still question if EM local currency bonds can continue to post relatively strong returns and outperform.

Our upcoming white paper, "Loco for Emerging Markets Local Debt and FX," outlines the dynamics that led to the underperformance of EM assets from mid-2011 through early 2016, why the asset class is now on solid footing following several years of headwinds, and the attractive relative value opportunities that exist within EM local debt and FX. The paper will be featured on PGIMFixedIncome.com in the coming weeks.

As we consider the EMD sector more broadly, we believe it should continue to provide solid opportunities in 2018. In particular, we would point to hard currency assets that trade wide to the major EM hard currency indices and to EM local markets with high real yields and contained inflation. In an environment of a stable-to-declining U.S. dollar, EM currencies stand to benefit as EM economic growth continues to outpace developed markets. Macro and idiosyncratic risks abound, however, making research and security selection crucial components of the investment process.

OUTLOOK: Positive. EMD opportunities include hard currency assets that trade wide to the major benchmarks and EM local rates with high real yields. EMFX stands to benefit from a stable-to-lower dollar as EM economic growth continues to outpace developed markets.

Municipal Bonds

In Q4 2017, AAA-rated municipal bonds outperformed US Treasuries 10 years and longer. Tax reform proposals to eliminate the tax-exemption for future advance refunding and private activity bonds (PABs) disrupted the normal year-end supply picture as issuers accelerated deals into 2017. As a result, Q4 supply surged to $145 billion and December set a record for monthly issuance at $62 billion. YTD supply totaled $436 billion, falling short of 2016's record of $445 billion. The final tax reform legislation preserves the tax-exemption for PABs, an important infrastructure financing tool, but eliminates the tax-exemption for advance refunding bonds issued after December 31, 2017. Other aspects of the tax reform bill that will have an impact on the municipal market include the reduction of the corporate tax rate to 21% from 35%. This will likely reduce demand from banks and P&C insurance companies; these investors held approximately 24% of outstanding municipal bonds (tax-exempt and taxable) as of September 30, 2017. While the new limitations on the SALT deduction could potentially lead to increased demand from retail investors in high tax states as they seek alternative ways to shelter income, longer-term credit implications for certain high tax states and localities will likely be negative.

A relatively stable rate environment contributed to steady mutual fund inflows, approximately $5 billion in Q4 and $18 billion in 2017. For the high grade and high yield indices, Q4 total returns were +0.75% and +1.83%, respectively, while YTD total returns were +5.45% and +9.69%, respectively. Long taxable municipal total returns were 2.60% in Q4 and 11.79% for 2017, underperforming the U.S. long corporate index. Excess returns for long taxable municipals of 641 bps, however, outpaced those of the long corporate index in 2017.

On the credit front, the state of Illinois, Baa3 negative/BBB-stable/BBB negative, sold $6 billion in tax-exempt bonds early in Q4 to begin to pay down the bill backlog, which peaked at $16.4 billion pre-debt issue. By late Q4, the bill backlog declined to $9 billion. Ability to continue paying down the bill backlog is an important factor in the state's credit trajectory.

We continue to believe that certain states and localities will struggle with long-term challenges related to underfunded pension and other post-employment benefit (OPEB) liabilities. However, we also recognize that states and localities generally have greater flexibility to reduce OPEB liabilities since they don't benefit from the same contractual and constitutional protections that pensions enjoy. In 2018, the U.S. Supreme Court will hear Janus v. AFSCME, a case which challenges the Illinois requirement that public employees who choose not to join a union must instead pay a fee ("fair share fee") to the union. If the Supreme Court rules in favor of the plaintiff, it will overturn a 1977 Supreme Court decision (Abood v. Detroit Board of Education), which sanctioned the collection of mandatory agency fees in the public sector. A ruling against the union would effectively turn every state into a "right to work" state and union membership would be

expected to drop significantly. Weaker unions could alter the political context for consideration of pension reform and other labor issues. Puerto Rico remains volatile as the commonwealth awaits additional federal funding for the rebuilding efforts. The judge and appointed mediators overseeing the bankruptcy case have several meetings between creditors and the commonwealth scheduled for Q1. Ultimate bondholder recoveries remain uncertain. As we've highlighted in the past, we do not expect that events in Puerto Rico will impact the broader municipal market.

Given the acceleration of supply into 2017, we expect that the technicals will be extremely favorable for tax-exempts in Q1, especially given January 1st reinvestment demand. A range bound interest rate environment should be supportive of mutual fund flows. Looking ahead, there's a potential to see an increase in taxable municipal supply given the loss of tax-exemption for future advance refunding bonds. An increase in supply would be welcomed as demand remains robust. Taxable municipals will likely perform in line with corporate bonds, with potential for outperformance should corporate M&A activity pick up.

OUTLOOK: Positive. Extremely favorable technicals in Q1 could lead to solid outperformance vs. Treasuries.

Source of data (unless otherwise noted): PGIM Fixed Income and Bloomberg as of January 2018

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Performance for each sector is based upon the following indices:

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

2018-

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