2nd QUARTER OUTLOOK

PGIM FIXED INCOME

April 2018

The Global Fixed Income Business of Prudential Financial, Inc.
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At Cruising Altitude With Seat Belts At The Ready

This edition of PGIM Fixed Income's Quarterly Outlook leads off with "Air Pockets at Cruising Speed—Welcome to QT" by Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds. In examining some prevalent market concerns, including quantitative tightening (QT), Tipp provides some perspective on how investors might consider these issues after Q1's volatility.

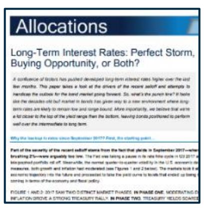
In "The Global Economy at Cruising Velocity," Nathan Sheets, PhD, Chief Economist and Head of Global Macroeconomic Research, explains how the balance in global fundamentals served as a stabilizing factor during the recent market turbulence. Sheets also looks at how U.S. fiscal policy, heightened trade tensions, and recent developments in China might affect conditions going forward.

What are the differences between LIBOR and SOFR (secured overnight financing rate)? What is the timing for the transition away from LIBOR? What is PGIM Fixed Income doing to prepare for the transition? As the market digests the recent release of the new SOFR rate—the proposed successor to LIBOR—we provide some answers to these client inquiries in "The LIBOR Questions."

If you'd like additional details about our Quarterly Outlook or would like to ask questions on the markets or global economy, please register for our upcoming Q2 Outlook Webinar, featuring Robert Tipp and Nathan Sheets, on April 17, 2018.

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

LONG-TERM INTEREST RATES: PERFECT STORM, BUYING OPPORTUNITY, OR BOTH?



LIBOR'S BORROWED TIME?

TRADE TENSIONS—STILL MORE BARK THAN BITE?

LOCO FOR EMERGING MARKETS LOCAL DEBT AND FX

Sector Views

Developed Market Rates (page 11, click to view): Opportunistic. The Q1 increase in developed rates created numerous opportunities. In the U.S., this includes buying when the 10-year yield approaches the top of its anticipated trading range, long positioning at the 7-year point on the curve, and a steepener from 7 to 10 years. In Europe, we favor long positioning in the 10-year bund and in certain peripheral countries as well as a 5-10 year versus 15-30 year steepener.

Agency MBS (page 11): Underweight as the Fed's balance sheet roll off weighs on the sector. We prefer seasoned bonds and 15-year maturities for better convexity.

Structured Products (page 12): Positive on top-of-the-capital structure structured products, especially CLOs and CMBS. We remain content to earn carry at current spreads. Negative on conduit CMBS mezzanine tranches as conduit credit quality is unimpressive. We're looking at financing trades rather than exposure to underlying assets as spreads are tight and the demand for leverage is high.

IG Corporate Debt (page 13): Mildly positive near term given favorable fundamentals, potential for improving technicals in April, and earnings growth momentum. Still favor U.S. money center banks. U.S. tax reform should provide further upside.

Global Leveraged Finance (page 14): Neutral. Our constructive near-term outlook is offset by longer-term risks, including tight spreads, elevated tail risks, possibly slower economic growth over the medium term, and potentially weaker, late-stage underwriting standards. In Europe, we are positive in the near and medium term, but less optimistic in the long term.

Emerging Market Debt (page 16): Positive. While the EMD sector could face short-term volatility from a number of uncertainties, i.e. mounting trade tensions, we continue to see opportunities across the sector as encouraging fundamentals pair with relatively attractive valuations.

Municipal Bonds (page 18): Positive. Favorable technicals in Q2 should lead to solid outperformance vs. Treasuries.

Air Pockets at Cruising Speed—Welcome to QT

Stock and credit markets continued flying high with little volatility at the start of 2018 on optimism regarding the economic outlook. Their smooth flight soon hit an air pocket, however, on concerns about the U.S. budget deficit's potential to destabilize markets by pushing up Treasury yields and pushing down the dollar. Later in the quarter, the markets floundered amidst rising concerns of trade wars, troubles among technology names, and—closer to the credit markets—concerns about M&A activity, which has been running high. Stocks covered a wide range during the quarter, at one point being nearly 10% off their highs. As Q1 concluded, Treasury yields were higher, credit spreads were wider, and stocks, on net, were little changed in the end (see Figures 1-3).

FIGURE 1: GLOBAL EQUITIES CONTINUED TO RISE INTO 2018 BEFORE HITTING A DOWNDRAFT AND THEN FLUCTUATING. AFTER ALL THE DRAMA, THEY ENDED Q1 WITH LITTLE NET CHANGE (INDEXED TO 100 AS OF 3/31/17).

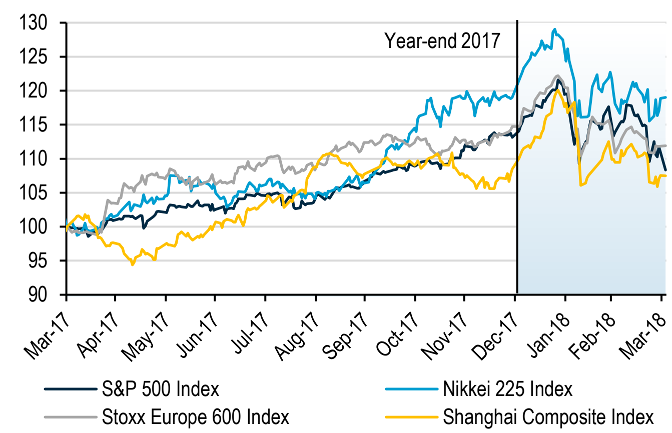


FIGURE 2: ALTHOUGH U.S. RATES ROSE IN Q1, THE NET CHANGES IN EUROPEAN AND JAPANESE RATES WERE MINOR.

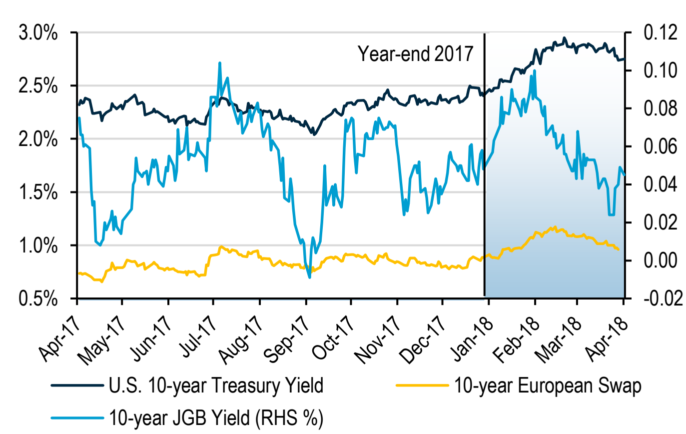
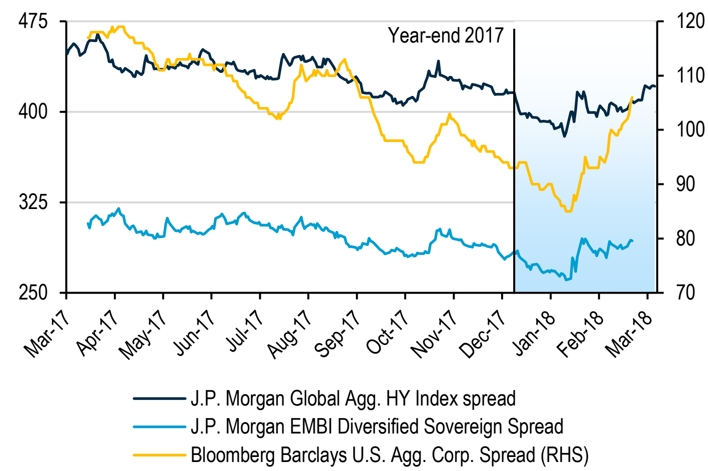


FIGURE 3: CREDIT SPREADS CONTINUED LAST YEAR`S RALLY IN EARLY 2018 BEFORE SELLING OFF. ON NET, SPREADS WERE WIDER IN Q1 (BPS).



Source for Figures 1-3: Bloomberg and PGIM Fixed Income as of April 2018

What caused the ruckus? Was it the news, or was it really the start of Quantitative Tightening (QT)?

While the news flow was probably worthy of the volatility, another development stands out: the liquidity environment is changing. Specifically, after years of central banks aggressively growing their balance sheets, that process is now leveling off, if not threatening to go into reverse. While the Bank of Japan is still buying—and likely to do so for some time—it is nonetheless reducing its purchases over time. The European Central Bank, for its part, is widely expected to end its purchases by year end at the latest. And as for the Federal Reserve, it was actually the first to enter the Quantitative Tightening mode—i.e., by letting assets roll off its balance sheet, it is draining liquidity from the system. All told, we have been in an environment where the major central banks were increasing their balance sheets, forcing liquidity into the system, and taking government securities out of the market. The liquidity injected via the purchases was probably pushed into higher-risk investments, thereby boosting their values and dampening market volatility. **In that light, as the slope of the asset line in the following chart has leveled off (and central banks on net have stopped injecting liquidity) maybe it shouldn't be so surprising that market volatility has risen, as shown in Figure 5.**

To make things worse, as the U.S. budget deficit widens, Treasury issuance will grow markedly in the quarters ahead as the G3 central bank balance sheets level off or maybe even begin to decline on net. **Similar to QT, this expansion of the budget deficit may divert money from riskier investments, effectively leaving the markets more volatile—and prone to bouts of spread widening—than during the periods of strong QE.**

FIGURE 4: G4 CENTRAL BANK ASSET GROWTH SET TO GO FLAT AS THE BOJ REDUCES PURCHASES, THE ECB ENDS ITS PURCHASES, AND THE FED ALLOWS ITS BALANCE SHEET TO ROLL OFF THROUGH MATURITIES.

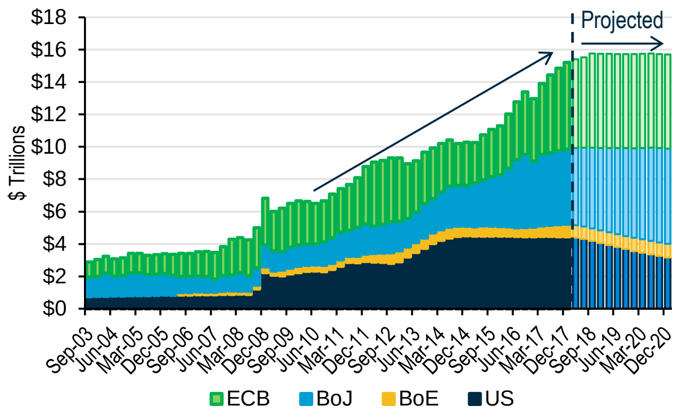
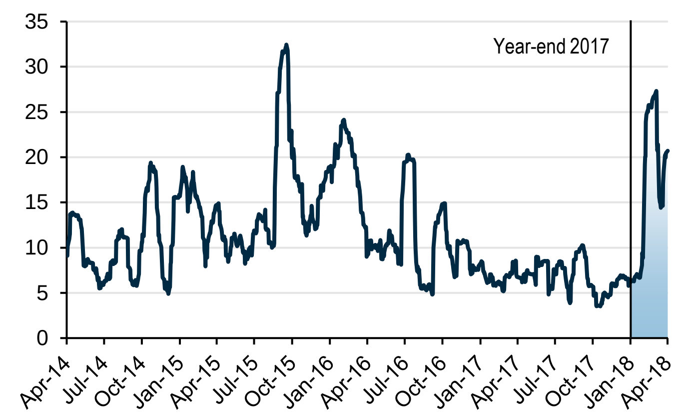


FIGURE 5: LAST YEAR'S DECLINE IN EQUITY VOLATILITY (VIX) REVERSED SHARPLY IN Q1 AS MARKET ANXIETY ROSE.



Source of Figures 4 and 5: Bloomberg, Haver Analytics, and PGIM Fixed Income as of April 2018. Assets are as of December 2017. There is no guarantee that the projections shown will be achieved.

What's next for rates? Fear the central banks, or stay ahead of the cycle?

Looking ahead for the bond market, two factors are critical: rates and spreads. In terms of rates, it is understandable that investors fear Fed rate hikes and the ECB's turn from accommodation to tightening. **However, the fact of the matter is that the markets often price in the impact of rate hikes early in the cycle. This may be especially likely in the current instance given the global backdrop where significant monetary tightening is priced into global yield curves in the years ahead, despite the fact that inflation has been stubbornly low. While on the face of it, in much of the developed world, rates are ostensibly quite low—in fact, what's priced into their forward curves suggests that normalization of monetary policy is both expected and accounted for by the markets, perhaps too much so, as indicated in Figures 6 and 7** (for additional details, see "[Long-term Interest Rates: Perfect Storm, Buying Opportunity, or Both?]").

FIGURE 6: SIMILAR TO THE 2004-2006 RATE HIKE CYCLE WHEN RATES CRESTED EARLY IN THE CYCLE, WILL THE HIGHS REACHED DURING THE TAPER TANTRUM DEFINE THE TOP OF THE RANGE IN THE CURRENT CYCLE?

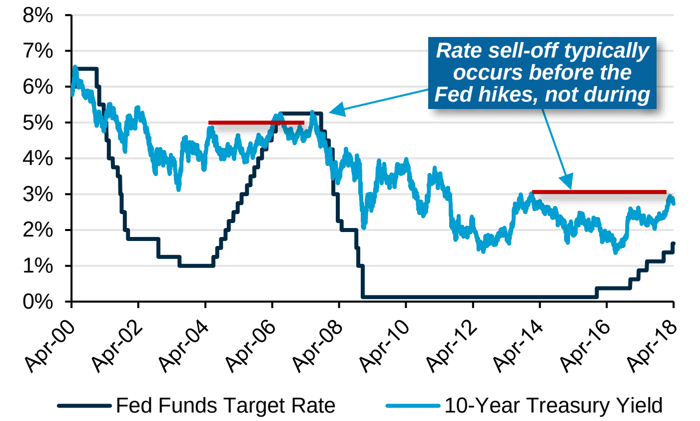
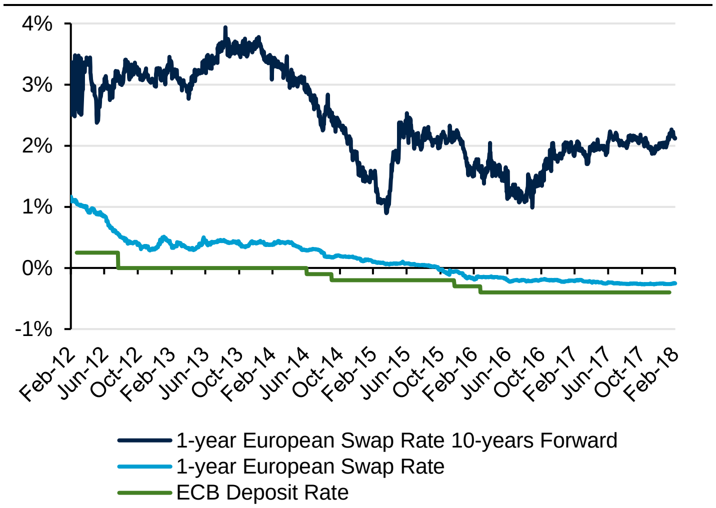


FIGURE 7: WHILE A 10-YEAR EUROPEAN SWAP RATE OF 1.1% MAY NOT KNOCK YOUR SOCKS OFF, THE FACT OF THE MATTER IS THAT THE EUROPEAN SWAP MARKET HAS PRICED IN OVER 200 BPS OF TIGHTENING OVER THE NEXT 10 YEARS...IN OUR VIEW, THAT IS LIKELY TO PROVE TO BE MORE THAN ENOUGH CUSHION, LEAVING BONDS POSITIONED TO OUTPERFORM CASH.



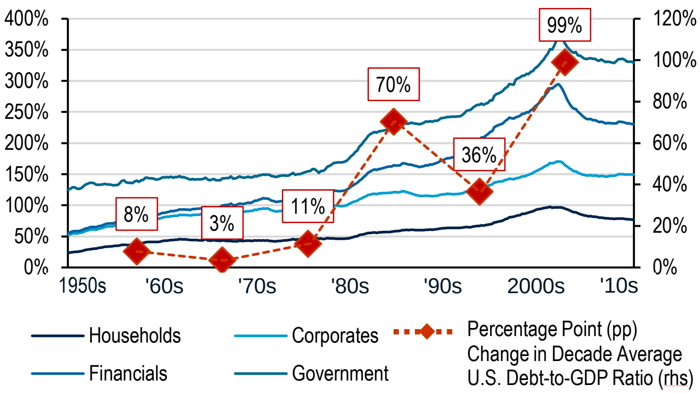
Source of Figures 6 and 7: Bloomberg and PGIM Fixed Income as of April 2018

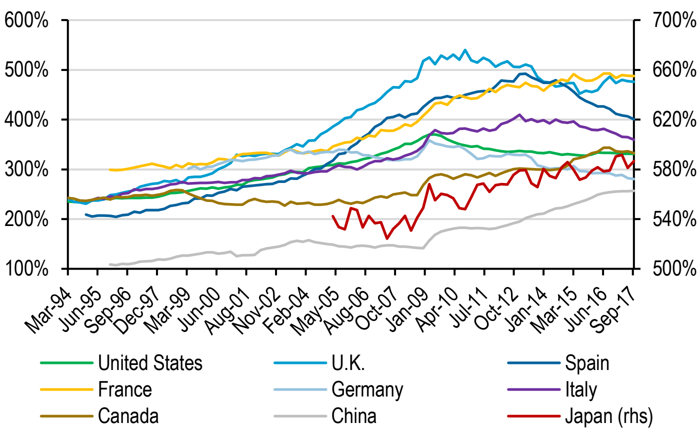
What about the credit cycle: Fear the technicals, or go with the fundamentals?

While this has already been a long economic expansion that has driven an extended period of spread product outperformance, this cycle may yet have a ways to go for a few reasons. First, the typical cycle ends when the economy heads south, and right now, that seems like a fairly distant prospect. **While it is tempting to look for the end of a cycle based on its age, in fact, two things typically conspire to bring about the end: 1) aggressive central bank rate hikes, and 2) a period in which debt has risen rapidly. On count #1, central banks appear to be very cautious in hiking rates this cycle and, therefore, less likely to "kill the patient" this time. On**

count #2, debt levels are generally not rising. So, while you can never be sure, the typical precursors of a bear market in risk product—aggressive central bank tightening and a credit bubble—appear to be some ways off, suggesting that investors should continue to selectively overweight spread product for some time to come.

FIGURES 8 AND 9: DEBT EXTENSION—A PRECURSOR OF DOWNTURNS—IS NOT MATERIALLY INCREASING IN THE U.S. OR IN THE PRIVATE SECTOR DEBT OF MOST DM COUNTRIES.





Source: Bloomberg and Haver Analytics. Debt-to-GDP data as of September 2017.

However, there are some caveats. First, spreads are not particularly wide, so excess returns from spread product are likely to be more modest than what recent years have brought (for reference, see the following table of returns).

FIGURE 10: DESPITE QUARTER-TO-QUARTER VOLATILITY, BONDS HAVE GENERALLY DELIVERED SOLID RETURNS DURING THE LOW AND RANGE BOUND REGIME IN PLACE FOR SEVERAL YEARS.

	Total Return (%)				
Multi-Sector	**Q1 2018**	**2017**	**2016**	**2015**	**2014**
Global Agg. Hedged	-0.12	3.04	4.0	1.0	7.6
U.S. Aggregate	-1.46	3.54	2.7	0.6	6.0
Euro Aggregate	0.73	0.68	3.3	1.0	11.1
Yen Aggregate	0.39	0.18	3.0	1.1	4.3
Global Aggregate	1.36	7.39	2.1	-3.2	0.6

Individual Sectors	Q1 2018	2017	2016	2015	2014
U.S. Long IG Corporates	-4.05	12.09	11.0	-4.6	15.7
EM Currencies	2.52	11.54	3.5	-7.6	-7.0
U.S. IG Corporate Bonds	-2.32	6.42	6.1	-0.7	7.5
EM Debt Hard Currency	-1.75	10.26	10.2	1.2	7.4
U.S. Leveraged Loans	1.58	4.09	9.9	-0.4	2.1
Municipal Bonds	-1.11	5.45	0.3	3.3	9.1
European High Yield Bonds	-0.45	6.79	10.8	1.3	5.1
European IG Corporate	-0.39	2.41	4.7	-0.6	8.4
European Leveraged Loans	0.74	3.72	7.0	3.6	2.1
U.S. High Yield Bonds	-0.91	7.48	17.5	-4.6	2.5
CMBS	-1.32	3.35	3.3	1.0	3.9
Mortgage-Backed (Agency)	-1.19	2.47	1.7	1.5	6.2
U.S. Treasuries	-1.18	2.31	1.0	0.8	5.1
EM Local (Hedged)	1.60	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 March 31, 2018. 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.

Second, event risk in investment grade corporates, and the usual idiosyncratic factors across all sectors, will continue to create risks, but also opportunities for adding value through active management. And third, the QT—central banks withdrawing liquidity—may lead to a more volatile environment than what we've generally witnessed over the last year or so.

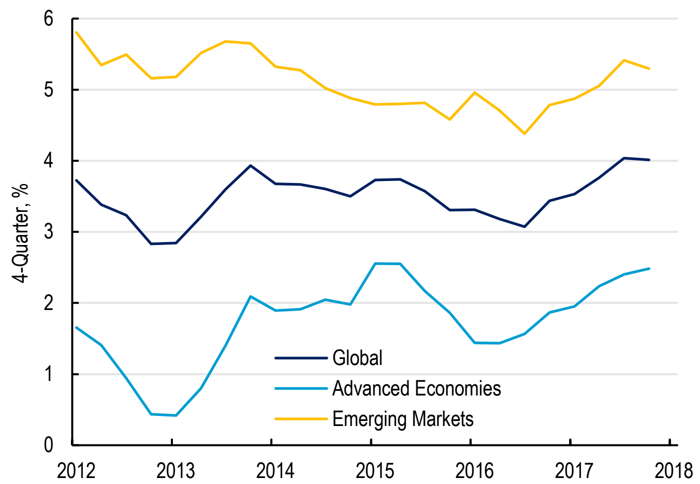
So, in conclusion, while we are expecting more volatility at this point in the cycle, we also expect rates to remain relatively range bound. And the ongoing economic expansion—which also appears likely to continue for some time—should allow an appropriately chosen selection of spread product to continue to outperform. **These combined factors—range bound rates and volatile, but stable to tighter, spreads—suggest the intermediate- to long-term outlook for the bond market remains favorable. We expect the U.S. dollar, on the other hand, to generally remain on a weakening tack. Just as fears of the Fed typically result in an early peak for long rates, the dollar is probably well past its strongest point, leaving non-U.S. currencies positioned to outperform over the quarters and years ahead.**

The Bottom Line: Bonds to continue to perform well over the intermediate to long term, with the higher yielding sectors likely to continue to post the best returns.

The Global Economy at Cruising Velocity

The global economy has reached cruising velocity, and prospects for the year ahead remain favorable. Global real GDP growth has leveled off at around 4% on a four-quarter basis, with growth rising over the past year in both the advanced and emerging-market economies.

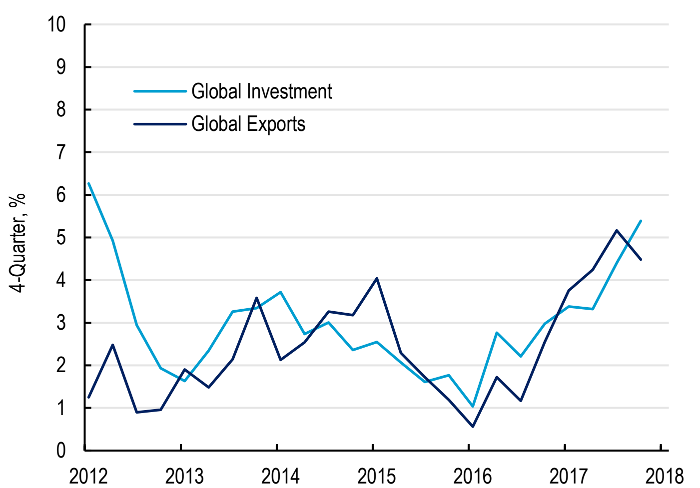
FIGURE 1: GLOBAL GDP GROWTH*



*Source: Haver Analytics and PGIM Fixed Income as of March 2018. *Purchasing Power Parity Weighted.*

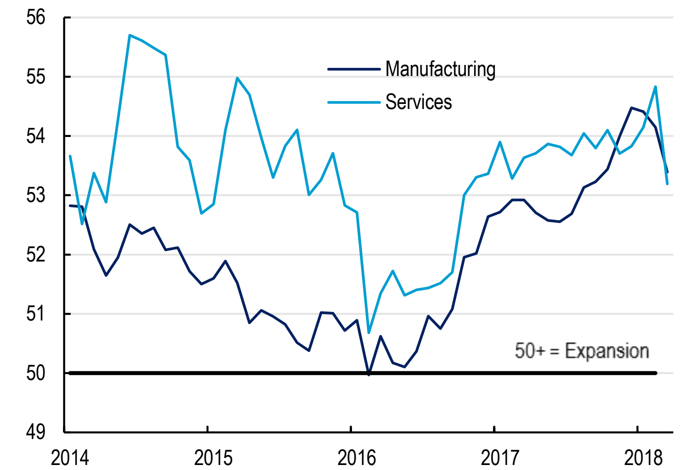
Global investment and trade are expanding at a firm pace, while purchasing managers indexes for both services and manufacturing remain comfortably in positive territory, despite a retreat in recent months. By our reckoning, all major regions of the world are recording solid and sustainable expansions.

FIGURE 2: INVESTMENT AND TRADE GROWTH



Source: Haver Analytics and PGIM Fixed Income as of March 2018

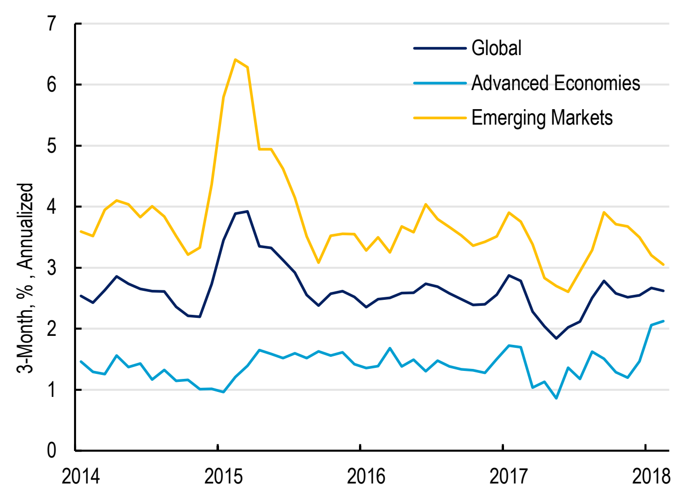
FIGURE 3: GLOBAL PURCHASING MANAGER INDICES



Source: Haver Analytics and PGIM Fixed Income as of March 2018

Inflation in some advanced economies has begun to edge up after a period of surprisingly low readings. These hints of renewed life in inflation, coupled with ongoing labor market tightening, have led central banks to consider the need for policy normalization and, in some cases, have prompted rate hikes. For example, the Federal Reserve, the Bank of Canada, and the Bank of England have already taken action and are expected to move again in the months ahead. Even so, such efforts are likely to remain gradual. In the emerging market economies, inflation also continues at a subdued pace.

FIGURE 4: GLOBAL CORE INFLATION



Source: Haver Analytics and PGIM Fixed Income as of March 2018

Taken together, these indicators highlight a broad-based "Goldilocks" expansion. Notwithstanding its increasing age, the expansion has considerable momentum. **The still-somewhat softer pace of growth than in previous recoveries has helped forestall imbalances. This, in turn, appears to be extending the life of the current cycle.** In the year ahead, we see continued solid growth in the advanced economies, including an acceleration in the United States, while growth in the emerging markets moderates a notch from last year's brisk pace.

As a related point, these well-balanced macro fundamentals were a stabilizing factor through the equity market volatility that erupted in February. Investors were comfortable with the trajectory of global economic growth and the prospects for company earnings, as well as with the path of inflation—and the monetary policy response—going forward. With these fundamentals in hand, market participants undertook a healthy re-examination of asset valuations given the favorable macro conditions.

While the overall thrust of macro performance has been in line with our expectations from three month ago, we have also seen some important changes in the broader environment. These changes are likely to influence the contours of global performance going forward and, in some instances, pose risks to the health of the global economy over the medium term.

U.S. Fiscal Policy—U.S. fiscal policy has shifted to a more stimulative trajectory with the passage of the tax cut last December and, more recently, an agreement to relax spending caps and expand defense spending. The multiple channels through which these measures will affect economic performance are a subject of vigorous debate. **But two observations are clear. First, these actions will support demand in the near-term, raising real GDP growth by roughly ½ percentage point over the next year. As a result, U.S. growth in 2018 is likely to approach 3%. Second, the U.S. fiscal deficit is likely to widen further.** Estimates suggest that these two agreements will add substantially to the federal debt over the next decade. Given the fiscal challenges associated with demographic aging, this further increase in indebtedness raises serious questions about the credibility of U.S. fiscal policy over the long run.

Trade Tensions—The U.S. has recently taken a more aggressive posture on trade policy. First, the Trump Administration announced a set of tariffs on imports of steel and aluminum. These measures were greeted with concern by U.S. trading partners, and in some cases elicited threats of retaliation. More recently, the Administration has also announced its intention to put 25% tariffs on imports from China totaling $50 billion, reflecting charges that China has unfairly appropriated U.S. intellectual property. China, in turn, announced its intention to place reciprocal tariffs on a comparable amount of U.S. imports, which has triggered threats of additional tariffs from President Trump. If trade tensions continue to escalate, with several rounds of retaliatory actions, the implications for global growth would be severe. **Given this reality, our expectation is that both sides will ultimately choose more moderate policies, although further flare-ups in rhetoric are likely.** That said, developments in this area are much tenser than we had anticipated three months ago and, accordingly, we are monitoring the situation closely (for additional details, please refer to "Trade Tensions—More Bark Than Bite?").

Developments in China—Over the past few months, the Chinese authorities have taken further steps in efforts to de-risk their financial sector. The pace of debt accumulation has slowed, in turn lowering investment growth and, recently, also consumption growth. To date, the overall slowing of the economy appears to be in line with the government's objectives, but the risks of unwelcome spillovers through trade and commodity channels persist. On the political front, President Xi has put in place a strong and experienced team to take the lead on economic and financial policies, but the decision to relax term limits on the President creates uncertainties about the political framework over the medium term.

Notably, all three of these developments—U.S. fiscal policy, global trade tensions, and Chinese rebalancing—ultimately have their roots in politics. And, more generally, uncertainty about political outcomes is an acute risk for the global economy. This is true in the United States for fiscal and trade policies and in China as it charts its course toward economic rebalancing. But it is also true in Italy as it seeks to piece together a government after the split election results; in the United Kingdom as it gropes for a cohesive approach to Brexit; and in Mexico and Brazil as economic performance is shaped by presidential elections. **In sum, we are optimistic about the outlook for the global economy through the year ahead. Over the longer run, however, we see reasons for caution. Given shifting global demographics, fiscal challenges, lagging productivity performance, and mounting political uncertainties, there are ample gray clouds on the horizon, which over time could create unwelcome challenges for global performance.**

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

United States

Following exceptionally strong private sector demand late last year, U.S. economic activity has become more mixed since the start of 2018. First-quarter real GDP growth is currently tracking at a little less than 2%, but that softness is expected to prove temporary. Some of the weakness is likely due to pay-back from a hurricane-related surge in demand in Q4 2017, and some may also reflect the pattern of first quarter weakness that we've seen in three out of the last four years. But the tax cuts are now taking effect, boosting household disposable income and creating more incentives, on the margin, for companies to invest. **The tax package, combined with increased government spending following the recent two-year budget deal, is expected to lift U.S. GDP growth from 2.3% in 2017 to 2.9% in 2018.**

Inflation is also expected to firm in the first half of 2018, given the low base effects from last year and residual price pressures from last fall's hurricanes. **Overall, though, we expect inflation to remain capped near 2% through the second half of this year, given continued competitive pressures in many industries, ample global production capacity, and ongoing disinflationary pressures from technology and demographics.**

We anticipate this combination of fiscal stimulus and firming inflation will likely keep the Fed on a trajectory for a total of three to four 25 bp hikes this year, with risks skewed towards four hikes at this point. The Fed's rate hike projections moved higher at its March meeting, with the majority of FOMC participants now split between three and four hikes this year. The Fed's median projection for 2019-2020 was also raised by another 25 bps, with the Fed funds rate reaching 3.4% by the end of 2020, modestly overshooting the Fed's median long-run estimate of 2.9%. **But the possibility of unforeseen negative shocks, e.g., mounting trade tensions that raise businesses'**

uncertainty about the outlook, a slowdown in U.S. growth, or further turbulence in asset markets, pose risks of a shallower rate path than the Fed is currently contemplating. Conversely, if inflation surprises on the upside, the Fed may hike more than its current projections imply.

Euro Area

In its fifth year, the momentum of the economic expansion appears to be peaking. Although remaining near their highs, conjunctural indicators have tended to roll over in Q1, including the bellwether German IFO and the EC's broad-based sentiment measure. Although all euro-area economies are enjoying an upswing, the dynamics differ across countries. On the one hand, record-low unemployment and high capacity utilization rates signal the possibility of overheating in Germany. On the other hand, ample (albeit declining) labor market slack suggests output gaps remain wide across the periphery. Against this backdrop, we expect growth to continue to comfortably exceed its potential but to moderate from 2.3% this year to 2.1% next year.

Inflation developments reflect these differences in the economic cycle. Inflation rates are subdued in the periphery, higher in the core countries, and markedly above the ECB's 2% target in the rapidly growing convergence countries, including in the Baltics. **In aggregate, inflation is likely to have troughed in Q1 and, amidst tightening resource constraints, is likely to reach 1.5% over the course of this year and to continue to edge up thereafter.** As unemployment rates have hit new post-unification lows, wage agreements in Germany are signaling a possible and long overdue end to wage moderation, thereby helping to underpin reflation prospects.

The ECB faces the task of balancing the need to curtail policy accommodation with the challenge of avoiding an untimely tightening of financial conditions or sustained currency appreciation. At its March meeting, the central bank dialed back its easing bias. By removing the possibility of larger asset purchases from its policy statement, the ECB took another step toward ending these purchases altogether. **A decision will likely be taken at the June meeting and, on balance, it appears more likely that asset purchases will be terminated in September, but certainly no later than by year end. However, a change to the forward guidance that policy rates will remain "low for longer" will likely be deferred, possibly toward year end.**

Japan

Following last year's 1.7% real GDP growth, the Japanese economy has continued its momentum this year. **We still anticipate that 2018 GDP growth will come in around 1.4%, exceeding Japan's estimated potential growth rate of around 1% for the second year in a row.** A pickup in business investment over the past year appears on track to continue, given strong capex orders and spending related to the 2020 Olympics. The labor market also remains robust, with hiring up 1.4% year-over-year in January, as labor force participation recorded a further rise. Spring wage negotiations also appear to be going well, with wage gains reportedly in the 2% range, against a backdrop of 1.0% CPI inflation, excluding fresh food, and 0.5%, excluding fresh food and energy as of February 2018.

With inflation continuing to undershoot the BoJ's 2% inflation target, however, BoJ Governor Kuroda successfully tamped down expectations of any move toward policy normalization this year. However, the land scandal embroiling PM Abe and his cabinet has made PM Abe's assumed reappointment as LDP president this September more uncertain. This has recently emerged as a key risk to Abenomics.

Emerging Market and Frontier Economies

We see growth in the emerging and frontier economies cooling a notch from last year's brisk pace. This is most evident in China, where the authorities are seeking to guide the economy to more balanced and sustainable growth. More generally, this moderation strikes us as likely necessary, given signs of incipient overheating pressures in some countries. Low global inflation trends have meant that these pressures have manifested themselves less in outright high inflation—though Philippines and Romania may be canaries in the EM inflation mine—and more in the form of worsening external positions, in countries as varied as India, Indonesia, Turkey, and Argentina.

The above observations notwithstanding, these countries began the year on a solid growth path reflecting the ongoing expansion in developed markets, accommodative domestic policies, and continued support from commodity prices. In addition, with many countries seeking to get ahead of rising Treasury yields, the pace of securities issued during the first quarter remained robust, with total issuance of $66 billion. Although down from the year-earlier pace, which spiked due to hefty Chinese issuance, this total was more than twice the first-quarter average of the previous five years. Notably, frontier markets have been active participants in this issuance, continuing along a borrowing trend that has worsened their debt ratios and increased their future external financing needs. The current situation, while not broadly problematic, warrants close monitoring in some cases. Oman, for example, has been a particularly heavy issuer. Despite the increase in oil prices, which has pushed up its budget revenues, the resulting fiscal adjustment has been modest and debt metrics have deteriorated rapidly. Ecuador is a similar case—chronic issuance needs stem from the underlying fragility of its fiscal and external positions. Egypt, in contrast, has recently taken steps to strengthen its fiscal policies.

As for the major Latin American countries, a severe drought besetting two of Argentina's main crops (soybeans and corn) has become a short-term headwind to the economy, leading us to revise our growth forecast downward to 2.5%. We expect authorities to counter the recent erosion in the credibility of the adjustment program by adhering to their fiscal targets and accelerating progress on Argentina's other challenging macroeconomic imbalances. In Colombia, the results from legislative elections and primaries bode well for a market-friendly outcome in the upcoming presidential election. In Mexico, the electoral environment is expected to heat up as the presidential campaign unfolds throughout the second quarter, ahead of the July 1st election. We expect that the left-leaning populist candidate will continue to poll competitively. These dichotomies in performance and conditions are partly driving the divergence of monetary stances in the region—tight in Argentina and Mexico and accommodative in Brazil, Chile, Colombia and Peru—which we expect to remain in Q2. In other regions, there has been good news from South Africa, as Cyril Ramaphosa replaced Jacob Zuma as President and launched a sweeping anti-corruption campaign. Much remains to be done, but the outlook for South Africa is brighter than three months ago. Presidential elections in Russia yielded the expected results, and the focus is now on whether re-elected President Putin will appoint an economic team that adheres to the current fiscally responsible stance and pursues structural reforms as well.

The LIBOR Questions

The following questions are some of those we've received from clients pertaining to the LIBOR-SOFR transition. For a more in-depth analysis, please refer to our recently published white paper, "LIBOR's Borrowed Time?" on PGIMFixedIncome.com.

How does SOFR compare to LIBOR?

SOFR offers several benefits over LIBOR as a benchmark—most notably being SOFR's construction on the basis of observable transactions—and as detailed by the following table, in which the bolded variables highlight the specific areas that SOFR has an edge over LIBOR.

Index	Transaction Based	Reliance on "Expert Judgement"	Underlying Volume	Other Short-Term Rate Correlation	Adaptability with Changing Markets
SOFR	**100%**	**0%**	**>$800B per day**	Yes	**Yes**
LIBOR[1]	25%	75%	<$1B per day	Yes	No

3-Month LIBOR between 10/15/2016 through 06/30/2017. Source: IBA 2017 Q3 Report on Volumes; Federal Reserve Governor Jerome H. Powell speech at the Roundtable of the Alternative Reference Rates Committee 11/2/2017.

SOFR is also less vulnerable to manipulation given substantial volumes of actual/verifiable trades. Conversely, LIBOR—despite recent improvements—continues to significantly rely on "expert judgement" or "market-data based" observations in setting borrowing costs in the absence of relevant actual transactions.

Additionally, as markets evolve, SOFR can easily be adjusted to include/exclude additional short-term transactions. **LIBOR is also quite rigid, and absent material restructuring, will continue to reflect the results of a survey of large banks that asks a single question *"At what rate could you borrow funds…by accepting interbank offers in a reasonable market size?".***

So SOFR is better suited in every way as a market reference rate?

Not just yet. While LIBOR has clear deficiencies—relative to SOFR—in its construction, the bolded observations within the variables in the following table demonstrate LIBOR's superiority in terms of usage flexibility.

Index	Tenors	Currencies	Number of Rates Produced Daily	Reflects Changes in Risk-Free Rate	Reflects Changes in Credit Spreads
SOFR	1 (overnight)	1	1	Yes	N/A
LIBOR	**7**	**5**	**35**	Yes	**AA/A Bank Credit Spreads**

1. *3-Month LIBOR between 10/15/2016 through 06/30/2017. Source: IBA 2017 Q3 Report on Volumes; Federal Reserve Governor Jerome H. Powell speech at the Roundtable of the Alternative Reference Rates Committee 11/2/2017*

The scope of SOFR is quite limited when compared to LIBOR and additional work will be required to enhance SOFR before it can effectively replace LIBOR. LIBOR is currently quoted in seven different tenors (1-day, 7-day, 1-month, 2-month, 3-month, 6-month, and 1-year) across five different currencies and also reflects a credit spread that corresponds to double-A/single-A bank risk. **SOFR, on the other hand, is only quoted on an overnight basis and represents a risk-free rate.**

SOFR also has some unique volatility and correlation characteristics. Specifically, SOFR is more volatile than LIBOR (most likely due to the nature of the benchmarks) and demonstrates significant quarter-end volume and rate changes.

SOFR is highly correlated with Treasury bill (T-bill) rates and issuance, and as T-bill volume ramps higher with increased financing needs in the U.S., the T-bill rate (and SOFR) should rise to attract sufficient demand. Given the recent suspension of the debt ceiling, the Treasury has indicated plans for record issuance volume in 2018, which should pressure T-bill rates (and SOFR) higher. LIBOR, while influenced by supply in short-term markets, is often more reflective of movements in bank credit spreads, particularly during times of financial stress.

What's next for SOFR?

Three material deficiencies need to be addressed before SOFR can effectively serve as a LIBOR replacement: 1) the need for a replacement Index for each LIBOR currency; 2) the development of a SOFR term curve; and 3) a means for reflecting a SOFR compensating spread (risk premium).

What is the timing for the transition?

The Alternative Reference Rates Committee (ARRC) has established a timeline for a phased transition to SOFR, with expectations for term SOFR rates to be produced by the end of 2021. **This coincides with the timeframe in which the Financial Conduit Authority will no longer compel banks to make LIBOR submissions, thus the timing leaves no room for error.** PGIM Fixed Income would note that there appears to be some market skepticism that sufficient liquidity will develop in new SOFR-based products, which is a prerequisite to deriving longer-tenor SOFR rates. It also seems that several market participants, including the current LIBOR administrator (Intercontinental Exchange Benchmark Administration—ICE BMA) seem to prefer that LIBOR continue to be reported post-2021, even if the method for developing the rate is changed.

How is PGIM Fixed Income preparing for the transition?

PGIM Fixed Income remains actively involved in the transition and has assumed active and leading roles in various trade association LIBOR-working groups (Commercial Real Estate Finance Council (CREFC), Loan Syndication and Trading Association (LSTA), and the Structured Finance Industry Group (SFIG) along with active involvement with the ARRC, the International Swaps and Derivatives Association (ISDA), and the Securities Industry and Financial Markets Association (SIFMA).

We also have been particularly active in drafting new fallback language for structured product transactions that allows flexibility given the uncertain nature of the ultimate replacement index while ensuring debt investors are paid an appropriate rate. As an example, PGIM Fixed Income has created a LIBOR fallback template for CLO transactions that has received some traction in the market and has been adopted by some issuers.

Is the significant widening in the LIBOR-OIS (overnight indexed swap) spread related to a transition away from LIBOR, and what's the outlook for the spread going forward?

We would attribute the widening in the LIBOR-OIS spread—which traditionally traded between 10-35 bps throughout 2017 and recently widened to 59 bps—to the confluence of increased Treasury bill supply, repatriation of corporate cash from tax reform, lumpy commercial paper maturities, and market illiquidity. Going forward, we believe more stable issuance of commercial paper and Treasury bills should limit further spread widening, and see the spread ranging from 40-50 bps for the balance of the year.

Developed Market Rates

Long-term developed market interest rates continued their ascent in Q1 amid further signs of synchronized global growth and the expected effects from U.S. fiscal stimulus. While the increase in rates was notable for its breadth, the scale of the selloff created numerous opportunities in the developed rate markets as the second quarter gets underway.

In the U.S., yields rose across the curve on hawkish Fed rhetoric, anticipated fiscal stimulus from the recently passed tax and budget deals, and increased Treasury supply (particularly at the front end). Given the increased funding needs, the Treasury announced that starting in February, the issuance of 2-year and 3-year notes will increase by $2 billion per month through April, while issuance along the remainder of the curve has risen by $1 billion for each auction. The Treasury will likely announce further increases to the sizes of its auctions at the May refunding.

Increased bill supply also amplified one of the more hotly discussed developments in the first quarter: significant widening in the LIBOR-OIS spread. The spread, which traditionally traded between 10-35 bps throughout 2017, widened to 59 bps from the confluence of increased Treasury bill supply, repatriation of corporate cash from tax reform, lumpy commercial paper maturities, and market illiquidity. Going forward, we believe more stable issuance of commercial paper and Treasury bills should limit further spread widening, and see the spread ranging from 40-50 bps for the balance of the year.

The U.S. 10-year yield crested at 2.95% in February and subsequently traded in a narrow 25 bps range through the balance of the quarter, and we anticipate a similar 2.65-2.95% range for Q2. **Should we prove correct, we would be constructive on duration at the top of the range considering the potential for yields to decline amid mounting trade tensions, heightened equity volatility, and potentially weaker U.S. economic growth. Furthermore, we favor the 7-year point along the Treasury curve as it appears particularly cheap, and given generally low term premiums, we also favor a curve steepener in the 7-year to 10-year portion of the curve.**

We continue to favor swap spread wideners in the U.S. out to 10 years due to the positive carry and roll down opportunities. We remain neutral on U.S. TIPS as the prospects for further Fed tightening offset the positive carry opportunities.

Elsewhere, we expect the 10-year JGB yield to trade in a range of 0-10 bps as the BoJ's QE and yield curve control programs continue through Q2. While the 10-year yield remained anchored around 5 bps in Q1, the 20-year JGB yield dropped 4 bps during the quarter to 53 bps.

In Europe, we hold a favorable view of 10-year bunds as we see several factors that could contribute to capping the yield at 0.75%. The market has priced in about 150 bps of ECB tightening over the next five years, which we consider excessive, and the yield spread may appear attractive to overseas investors. The ECB's QE purchases also means there will be zero net issuance into the market. That said, the ECB tapered its monthly QE purchases from $60 billion to $30 billion in Q1, and it could announce a conclusion to the purchases in September 2018, albeit with reinvestments likely to continue. The ECB's first rate hike could emerge by the second quarter of 2019. **We also favor a 5-10 year versus 15-30 year curve steepener given the positive carry and roll down opportunities. We also have a positive view on certain peripheral spreads.**

OUTLOOK: Opportunistic. The broad increase in developed rates in Q1 created numerous opportunities going forward. In the U.S., these include buying when the 10-year yield approaches the top of its anticipated trading range, long positioning at the 7-year point on the curve, and a steepener from 7 to 10 years. In Europe, we favor long positioning in the 10-year bund and in certain peripheral countries as well as a 5-10 year versus 15-30 year steepener.

Agency MBS

Unsettled risk markets, higher implied volatility, smaller Fed purchases, and dramatically worse dollar-roll performance all took their toll on the agency MBS market in Q1 as the sector cheapened relative to U.S. interest rates. Despite the cheapening to start 2018, we continue to believe that MBS will face pressure going forward as the effects from the Fed's balance sheet roll off mount. The excess return of MBS in Q1 (-39 bps) put it in mixed territory vs. other high-quality sectors.

The Fed's presence in the MBS market will continue to recede amid the combination of the scheduled balance sheet roll off and the slowing prepayment conditions following the jump in interest rates in Q1. Indeed, prepayment speeds during the quarter declined back to the lows from early 2017 as the average rate on a 30-year primary mortgage rose to 4.625%, more than 50 bps higher than November 2017 and the highest level since 2014.

The slow prepayment environment is expected to continue in Q2 if 30-year primary mortgage rates remain around 4.5% or higher. With a weighted average coupon of 3.53% and an average dollar price of $101, it is thought that less than 10% of the MBS universe is a candidate for refinancing at this point. **With higher coupons benefitting the most from the decline in prepayment speeds, our preference in Q1 for 3.5% issues in the middle of the coupon stack underperformed the higher-coupon issues.**

In Q1, Ginnie Mae prepayment speeds remained elevated relative to Fannie Mae and Freddie Mac, contributing to the underperformance of Ginnie Mae issues during the quarter. While we expect various efforts on behalf of Ginnie Mae to dampen some undesirable, non-bank prepayment behavior in the future, we believe the market will remain cautious on the sector until the speeds converge with the broader universe.

Looking ahead, some positive elements could influence the sector's performance, including dampened origination volume in the spring and summer due to the increase in primary mortgage rates. In addition to benign prepayment speeds, model durations have largely extended and convexity hedging has slowed as rates stabilized. **We're also monitoring factors that could serve as a backstop into wider spreads, including a buyer base that generally remains underweight the sector and the potential for overseas buyers, who have been relatively quiet this year, to emerge if rates reach their yield targets. Indeed, as Q1 concluded, we observed an uptick in overseas buying activity.**

The positive factors are offset by some significant negatives, leading with the pending increase in the Fed's reinvestment cap to $12 billion from $8 billion. Under that cap, the Fed's purchases are expected to remain at $10-$15 billion per month over the next few months before dropping below $10 billion in July. The Fed's reduced presence will result in an increase in net supply for the market to absorb. In addition, dollar rolls have cheapened, and they continue to trade flat versus one-month LIBOR, resulting in no financing advantage for TBAs.

Given that backdrop, we favor seasoned bonds and 15-year maturities for better convexity as the Fed's balance sheet reduction continues.

OUTLOOK: Underweight as the Fed's balance sheet roll off weighs on the sector. We prefer seasoned bonds and 15-year maturities for better convexity.

Structured Products

Our preference for up-in-capital structure trades not only continues, but is more emphatic, given the current level of spreads and increased market volatility. In Q1, spreads generally ground tighter but struggled as the quarter closed, with CMBS AAAs roughly 10 bps wider. We continue to advocate a more defensive positioning with an emphasis on senior financing trades. We believe these bonds have superior carry to many other high-quality spread products and should outperform in a market downturn due to significant structural protections. **Our favorite positions within structured products are AAA-rated CLOs and CMBS.**

Non-Agency RMBS: The impressive multi-year spread rally has taken the "extra" value from legacy non-agency bonds. In our opinion the sector is, at best, fairly priced, with base case spreads on loss taking bonds around LIBOR +100 bps. While the sector could benefit from an expected strong residential housing market, which could improve the likelihood of mortgage payments and increase recoveries on defaulted loans, idiosyncratic risks abound. These risks include trustee litigation reserves (for example, Wells Fargo withheld funds from bondholders on deals called via the clean-up option to indemnify itself from litigation expenses where Wells is the defendant); realization of forbearance recoveries, which are increasingly priced into bond valuations; and lower-than-expected recoveries on defaulted loans that have been in the foreclosure pipeline for years. We also think GSE credit risk transfer bonds are fully priced, with the nearly two-year spread rally having given way to range bound trading levels. We are wary of CRT supply technicals as the GSEs have a mandated requirement to "layoff" an impressive amount of credit risk**. Despite this blasé outlook for the sector generically, we see pockets of value in financing RMBS assets rather than owning the underlying outright—particularly RPL, NPL and Re-REMICs, with spreads on senior positions ranging as high as L + mid 200s.**

Away from the U.S., UK RMBS credit performance was stable and spreads were rangebound Q1. We are neutral on senior non-conforming paper with generic spreads currently L+60-70 bps, and we are selectively considering 5-yr+ seasoned 2nd pay classes trading 100-110 bps. Potential market headwinds continue to be a cooling UK housing market, consumer affordability concerns, and Brexit-related uncertainty. **Opportunities in peripheral non-performing loan securitizations are increasing as Spain and Italy make progress in cleaning up bank balance sheets.**

CMBS: AAA CMBS spreads were not immune to general market spread volatility during Q1. Spreads rallied about 15 bps through January and into early February to post-crisis tights, swaps + mid-60s, before giving way to market volatility. They now trade at Swaps + mid-80s. **We believe spreads are fairly valued here, but would not be surprised if CMBS spreads widened further as other sectors, such as IG/HY corporates have widened more since market volatility picked up in February.** Fundamentals for CRE are mixed. On the positive side, commercial real estate prices have eclipsed the 2007 peak for some time now, and appreciation in 2017 was a strong 8% in 2017. However, performance across submarkets and property types has been uneven, and we expect pockets of continued weakness – e.g., retail and suburban offices. **Further, we would not be surprised to see valuation softness if capitalization rates increase with interest rates. We continue our main investment themes in CMBS—front-pay 10-year tranches off conduit securitizations, interest only tranches, and select mezzanines off SASB transactions with favorable underlying CRE stories. We remain negative on conduit mezzanine tranches due to unimpressive underwriting quality and low structural support.** Mezzanine tranches from deals originated in 2012 and 2013, as well as CMBX from those vintages, reached new wides in Q1—CMBX6 BBB- (2012) is currently 703 bps and CMBX7 BBB- is now 557 bps. Supply has been on the low side with conduit issuance for the first quarter around $9.6 billion, up from $9.4 billion in Q1 2017 and lower than the $14.7 billion issued in Q4 2017. **For all of 2018, we expect issuance to be down 20% to $70 billion for all private label and conduit issuance around $40 billion. While these lower levels of issuance are supportive of spreads, we think CMBS spreads will take their direction from the broader markets.**

CLOs: Globally, we remain constructive on AAA tranches as we consider them to be among the cheapest bonds in the fixed income universe on a risk-adjusted basis. AAA CLOs benefit from significant credit enhancement and industry diversification across the underlying senior secured collateral backing the bonds. We are more cautious further down the capital structure given that current valuations do not reflect the potential downside of future negative economic conditions. In part, we believe current mezzanine valuations do not reflect expected lower senior secured recovery rates due to increasing leverage and weaker documentation. However, we believe synchronized global growth will continue, supporting a very benign default environment amid strong corporate balance sheets. We expect AAA spreads to resume tightening as there is significant global demand for high-quality bonds, and in the U.S. the prospects of higher LIBOR will entice yield seekers. U.S. AAA spreads are now between 3L+ 98-105. In Euro AAAs, spreads are 3E+85-91 (including the Euribor Floor). **We continue to expect robust issuance across primary, resets and refinancings. We believe reset and refinancing activity will pick up early in Q2 as risk retention requirements are currently not applicable (due to successful repeal) in the U.S. We believe this issuance increase will slow spread compression as supply meets global demand. We believe the market will continue to experience positive net issuance and expect at least $50 billion through year end (expect a record breaking year of gross issuance). We remain focused on the effects of the widening in LIBOR-OIS and its effects on cross currency basis as many global investors may shift their demand for certain bonds as costs or benefits of hedging change.**

ABS: Consumer balance sheets remain healthy with a solid employment backdrop and continued lower levels of leverage. We do not believe consumers lenders have been exploring, en masse, the speculative universe of consumer credits. Nevertheless, the marginal borrower in unsecured and secured ABS is still, almost by definition, stretched financially, and monitoring lenders origination quality remains paramount. **We continue to favor unsecured consumer loan and subprime auto ABS across the capital structure from originators with strong legal and compliance procedures and a bias towards cashflow underwriting models. We also like paper from refinance student loan lenders that underwrite originations, again, using borrower cashflows.** Concerns for us include used car prices, where we are looking for structural enhancements to mitigate exposure to car prices, and marketplace lending, which in our opinion is populated by firms with uncertain business models. On the technical front, relatively heavy new issuance, coupled with increased secondary market selling, has applied some widening pressure, about 5 bps, to senior class front-end "commodity-like" ABS sectors such as credit cards and autos, previously trading at or near post-credit crisis level tights. New issuance of $65 billion in Q1 has significantly outpaced 2017.

OUTLOOK: We remain positive on top-of-the-capital structure issues, especially CLOs and CMBS. We remain 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 underlying assets as spreads are tight and the demand for leverage is high.

U.S. and European Corporate Bonds

Despite still favorable fundamentals, Investment grade corporate bonds weakened in Q1, buffeted by rising interest rates, market volatility, political and trade policy rhetoric, and a shift in investor sentiment to reduce risk. During the quarter, U.S. corporate spreads widened by +16 bps and posted an excess return of -79 bps to similar-maturity U.S. Treasuries.

European corporate bond spreads also widened in Q1 as politics and supply came back into play and investors followed the risk-off tone of the U.S. markets. However, the ECB's corporate bond buying program and positive economic momentum continued to provide support.

	Total Return (%)	Spread Change (bps)	OAS (bps)
	Q1	Q1	3/31/2018
U.S. Corps.	-2.32	+16	109
European Corps	-0.39	+9	95

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

U.S. Corporate Bonds

After a strong start to the year, U.S. investment grade corporate bonds came under pressure amid an increasingly risk-averse and volatile climate. Against this backdrop, we see both positives and negatives across the corporate market, which should make individual security selection a key driver of returns going forward.

On the one hand, overall credit fundamentals remain solid, supported by a positive global economic growth and no clear sign of a recession on the horizon. First quarter 2018 earnings are forecast to rise 17.3%, with more than one-third of the increase driven by recent tax reform. Free cash flow and profit margins are strong, and corporate liquidity is robust.

Investor demand is also supportive although demand from non-U.S. investors waned a bit in Q1 due, in part, to currency hedging costs. New issues were oversubscribed, on average, although excess supply to fund mergers and acquisitions weighed on the market and longer-term issuance rose given a flattening of the corporate yield curve. In addition, companies are allocating more money to underfunded pension plans. Not only are contributions deductible at 2017 tax rates until September, but the Pension Benefit Guaranty Corporation increased its premium (to 4%) on the underfunded portions of U.S. corporate pension plans. We believe these additional contributions should support long-duration corporates as pension plans gradually rotate their allocations from stocks to bonds.

On the other hand, the Federal Reserve's well-telegraphed plan to raise short-term interest rates, trade tariffs, and wariness over late credit cycle fallout have come to the forefront. As is typical at this stage in the cycle, event risk in the industrial sector is on the rise and higher business confidence among corporate management may lead to even more M&A and aggressive balance sheet behavior.

In this environment, 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 we believe should remain subject to higher capital requirements even if other post-financial crisis regulations are relaxed. Post-event new issues are providing select opportunities, as are "U.S.-centric issuers" as well as issues in the pharmaceutical and energy industries. 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 BBB-rated corporates.

Given the Q1 backup in spreads, we are slightly more positive on intermediate and long-duration maturities in the near term in anticipation of improving technicals—amid a slowdown in new issue supply in April and continued pension demand—and expectations for a strong earnings season.

European Corporate Bonds

European corporate bonds held up better than U.S. issues in Q1, but were also fairly volatile. After hitting their post-financial crisis tights early in the period, spreads ended the quarter 9 bps wider at 95 bps. Despite solid support from the ECB's bond buying program, a combination of excess new supply, politics, and U.S.-led volatility weighed the market down.

Issuance was strong through March, on par with 2017 levels. Financial issuance dominated the first few months. Corporate issuance then increased substantially, including several outsized deals, which, combined with increased market volatility, pushed spreads wider.

On the political front, the Italian election/coalition talks and Brexit outcome remain in flux, while trade tariffs and a search for Mario Draghi's successor (in H2) add to uncertainty. U.S. economic data also leaked into the mix with volatility from U.S. inflation prints feeding straight into European spreads despite inflation not being a significant issue for the Eurozone.

In fact, European economic data (ex-UK) is solid and credit fundamentals remain robust. As there does not appear to be any impending triggers likely to substantially derail the markets, our current outlook is far more technical: increasing net issuance, tight spreads fighting with the ECB's bond buying program, and a constant demand for yield. In addition, the cross-currency basis is making the Euro market more attractive to non-USD buyers outside the euro zone.

In European portfolios, we trimmed risk early in Q1 as there were few attractive opportunities. In light of recent spread widening, we moderately raised our risk exposure given more attractively-priced new issues and generous concessions (at times 15-25 bps). **We remain overweight U.S. banks, insurance, and non-core REITS. We continue to hold an overweight in non-euro and non-ECB eligible issuers, although on a lower scale give the significant spread compression.**

In global corporate portfolios, we are also overweight risk despite tight spread levels, and have trimmed some euro exposure in favor of U.S. spreads. We have also reduced exposure to companies with potential tail risk that we believe are prime candidates for spread widening. **Similar to European portfolios, we hold an overweight in U.S. money center banks and insurers, and we favor strong and "post-event" BBBs over single-A rated corporates that are potential large M&A candidates or that have more shareholder-friendly boards. 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 the recent spread back-up should provide attractive opportunities given still positive fundamentals, ongoing investor demand for yield, and small recession risk in the near term. Downside risks include more aggressive than-expected central bank tightening, regional and global geopolitical risks, and, longer-term, China's contribution to global growth.

OUTLOOK: Mildly positive near term given favorable fundamentals, potential for improving technicals in April, and earnings growth momentum. Still favor U.S. money center banks. U.S. tax reform should provide further upside.

Global Leveraged Finance

The high yield market cut both ways in the first quarter, as the strong start to the year gave way to the pressures from declining equity markets, rising rates, and consistent outflows from the asset class.

	Total Return (%)	Spread Change (bps)	OAS/DM (bps)
	Q1	Q1	3/31/2018
U.S. High Yield	-0.91	+9	372
Euro High Yield	-0.45	+33	327
U.S. Leveraged Loans	+1.58	-20	396
Euro Leveraged Loans	+0.74	0	392

Sources: ICE BofAML and Credit Suisse as of March 31, 2018. 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

The U.S. high yield market began 2018 with a strong tone, moving higher early in the year on optimism that U.S. tax reform would spur economic growth, as well as a solid technical backdrop, which featured elevated manager cash balances and limited new-issue supply.

Despite the rising rate environment, high yield spreads rallied to post-crisis tights of +323 bps in January. However, increasing stock market volatility and a sharp rise in the VIX spooked investors and sparked outflows, which subsequently sent spreads to year-to-date wides of +382 bps in early February. While rates initially began to stabilize towards the end of Q1 (helping spreads tighten gradually), continued weakness in equities, negative net flows, and rising concerns over potential trade wars continued to weigh on the asset class as the quarter drew to a close. Overall, spreads widened by +9 bps during the quarter, ending with an OAS of +372 bps

U.S. high yield returned -0.91% in the first quarter, and lower-rated credits continued their outperformance of the higher-rated segments of the market. CCCs posted excess returns of +88 bps, compared to +23 bps for Bs, and -74 bps for BBs. This marks the eighth quarter out of the last nine in which CCCs have outperformed BBs.

Aerospace was the top performing sector in Q1, returning +1.6%, driven higher by the performance of Bombardier, which raised $600 million in an equity offering and improved its balance sheet in its effort to close its C-series partnership with Airbus SE. The retail sectors were also among the top performers after a poor showing in 2017. Food & drug retail returned +0.6%, helped by a rally in the bonds of Rite Aid from near-distressed levels following the announcement of its acquisition by the grocer Albertsons.

After ending the fourth quarter of last year as one of the bottom performing sectors, cable was the worst performing sector in Q1 with a return of -2.6%. The auto sector also lagged (-2.3%), driven lower by Tesla, whose bond prices fell by approximately seven points in March. The food and beverage (-2.2%) sector was also a notable underperformer.

Moody's 12-month U.S. speculative grade default rate ended February at 3.6%, a slight increase from the rate of 3.3% at the end of 2017. The retail sector led the way in terms of global default activity as it accounted for five of the 17 defaults thus far in 2018. This comes after a challenging 2017, when the sector notched 13 defaults. Stress throughout the retail sector will likely continue for the first half of 2018. Looking ahead, Moody's expects the U.S. default rate to fall to 2.0% over the next 12 months amid global economic momentum, generally good liquidity, and low refinancing risk.

High yield bond funds reported outflows of -$19.2 billion in Q1, including an eight week stretch in which bond funds incurred outflows of -$16.5 billion, or nearly 8% of high yield mutual fund AUM. Of note, the $12.4 billion reported outflow in February marked the second largest monthly withdrawal, trailing only June of 2013, which posted $13.6 billion in outflows.

The new issue pipeline was slow to develop during the first quarter, due primarily to reduced demand for the asset class, issuers' reluctance to bring deals at higher yields, and issuers' utilization of alternative sources of inexpensive financing, such as bank loans. For the year, 131 deals have priced, for $73 billion in proceeds, which represents an almost 25% decline compared to the same period last year. For context, the $13 billion of primary market supply in February marked a two-year low for total monthly issuance. The energy sector continues to dominate primary market issuance, accounting for 27% of new issue supply in Q1, with no other sector surpassing 10% of activity.

We remain constructive on U.S. high yield in the near term due to improving fundamentals and favorable technicals which are supported by limited net supply and strong institutional demand, particularly from Asia. We are not as bullish longer term due to the threat of potential tail risks in this tight-spread environment, the possibility of an economic contraction two to three years down the road, and deteriorating underwriting standards as we enter the last phase of the credit cycle.

In general, we expect defaults to remain low over the next two years, despite risks posed to select sectors, particularly retail, wireline telecom, and healthcare. We remain cautious on commodities and are maintaining an overweight to independent power producers and U.S. consumer-related issuers. We continue to find the best relative-value opportunities in CCC-like issuers (which we expect to erode over time as the market's risk

appetite firms), while hedging beta with elevated cash balances and allocations to AAA CLOs.

With continued support from a strong CLO bid and solid retail demand from investors looking for interest rate protection, the S&P/LTSA U.S. Leveraged Loan Index was able to navigate through the wave of market volatility, returning +1.6% in Q1. Lower rated loans—although only approximately 5% of the index—continued to outperform, as CCC loans returned +2.8% during the quarter, outpacing Bs and BBs by 126 bps and 158 bps, respectively.

In contrast to high yield bond funds, loan funds reported inflows of $3.7 billion for the quarter, adding to the $13.1 billion of inflows into the asset class in 2017.

New issue volume in the loan space was also subdued in Q1, particularly when compared to the record issuance set last year. In total, 395 new deals worth $242 billion in proceeds came to market during the first quarter, compared to 337 issues, totaling $279 billion in Q1 2017. Similar to previous quarters, issuance was dominated by repricings and refinancings, which accounted for 47% and 22% of all activity, respectively. As was the case in Q4 2017, the technology sector was the biggest contributor to the new issue market in Q1, representing 19% 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.

The U.S. leveraged loan market is off to a very strong start in 2018, and while the current technical backdrop remains favorable, deteriorating underwriting standards within the asset class is cause for concern and leaves us with a less constructive relative value view over the medium and longer term.

European Leveraged Finance

The broad European high yield index returned -0.45% in Q1. Positive broad market returns in January were quickly overwhelmed by global interest-rate volatility, equity market declines, and sustained European credit fund outflows, underscoring the negative monthly returns in February and March. Spreads widened +33 bps year-to-date to 327 bps and are now +80 bps wider than the post-crisis tight of +247 bps that was set in November of last year.

Single Bs continued to outpace the higher-rated, more rate-sensitive segments of the high yield market in the first quarter, returning +0.12%, compared to BBs which returned -0.63% and CCCs which returned -0.28%.

Primary market activity was subdued in Q1, with new issue volume trailing last year's pace by 20%. New issue supply totaled €19.6 billion (from 37 issuers) year-to-date, compared to €24.4 billion over the same period last year. Additionally, of the issuance to come to market during the quarter, €2 billion has originated from debut issuers, down from the €4.8 billion that priced in Q1 2017.

Moody's European default rate ended February at 2.8%, increasing from the 2.6% at the end of Q4. Looking ahead, several factors remain supportive of our expectations for defaults to remain low over the next 12 months, particularly, forecasts for the European economy to continue to grow slowly, issuers opportunistically taking advantage of favorable market conditions to refinance debt, the lack of a major near-term maturity wall, and the potential for a significant amount of HY to IG credit migration as issuers remain dedicated to reducing leverage and obtaining investment-grade ratings.

European leveraged loans returned +0.74% in Q1, and the outlook for the asset class appears favorable given strong investor demand, elevated levels of managed account loan money, increased CLO formation, robust demand from banks, and expectations for future rate increases.

Loan issuance has stayed on pace with last year's record total, with €25 billion of new issuance in January and February alone. Despite a drop-off in loan supply in March, €35 billion of new issuance came to market during the first quarter. In general, the market has remained highly supportive of the new deals, and should be able to absorb the record supply given the strong technical backdrop for European leveraged loans.

Our expectation is that spreads may continue to tighten slightly from current levels given improving fundamentals, reduced political risk, and a decent macro environment with little recession risk in the near term. Furthermore, we do not believe that the ECB will take action that jeopardizes Europe's recent economic growth. However, ongoing macro concerns (North Korea, pan-European politics, etc.), combined with potential aggressive underwriting resulting from tight spreads and continued demand for leveraged finance products leave us with a less bullish view longer term.

We favor B-rated issuers and continue to tactically increase our BB allocation through the primary market. We continue to seek attractive relative-value opportunities between sterling-denominated and euro-denominated bonds. We also expect loans will continue to outperform bonds in the near term.

OUTLOOK: Neutral. Our constructive near-term outlook is offset by risks to our long-term view, which include tight spreads and elevated tail risks, possible economic slowdown 2-3 years out, and potential deterioration of underwriting in this late stage of the credit cycle. In Europe, we are positive in the near and medium term, but less optimistic in the long term.

Emerging Market Debt

The emerging market debt sector started 2018 in mixed territory as the mid-quarter volatility pushed hard currency spreads wider. Importantly, the sector has maintained its positive economic momentum, and when combined with relatively attractive valuations, these factors support our positive view on the sector going forward.

	Total Return (%)	Spread / Yield Change (bps)	OAS (bps) / Yield %
	Q1	Q1	3/31/18
EM Hard Currency	-1.75	+19	304
EM Local (hedged)	1.60	-14	6.01%
EMFX	2.52	+17	3.71%
EM Corporates	-1.12	+9	280

Source: J.P. Morgan as of March 31, 2018. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

Emerging market fixed income started the year with a very strong January, with hard currency spreads tightening from 285 bps to 265 bps and the local index returning +4.48% on the back of stable yields and appreciating currencies. This was followed by a soggier February and March as inflation fears, trade war rhetoric, spikes in volatility, and rising U.S. rates drove investors to the sidelines. For the quarter, the hard currency sovereign index was down 1.75%, with spreads widening 19 bps to 304 bps. Local markets continued the outperformance vs. hard currency that started in 2017, returning a positive 1.60% despite giving back approximately 1/3rd of January's gains.

Local market country returns (unhedged) were generally positive, led by South Africa (+13.29%), Mexico (+10.88%), and Colombia (+8.75%). South Africa markets were bolstered by the selection of reform-minded Ramaphosa to head the African National Congress, while Mexican assets rallied from oversold levels as investors became more comfortable with the outlook for NAFTA negotiations and the upcoming presidential elections. Most hard currency country returns were negative, with Venezuela being a surprising exception as the top performer with a return of +11.60%. Despite worsening economic conditions and falling oil production, investors bought into the belief that President Maduro would eventually be forced from office and that the restructured value of bonds would be greater than the current prices in the $20s.

New issue supply was a large $187.2 billion during the quarter, with about $66 billion in sovereigns and the rest from quasi-sovereigns and corporates. The run rate of this supply is part of the reason for the spread widening during the quarter. The good news is that many countries have completed their planned issuance for the year, including Argentina, Philippines, Mexico, Ivory Coast, Egypt, and Kenya. Additionally, the greatest amount of corporate issuance came from China (~$47 billion), where the predominant buyers are on-shore Chinese investors. Going forward, a large part of issuance is expected to come from Mideastern sovereigns, Chinese corporates, and eastern European countries in euros, which should improve the market technicals.

Offsetting this new issuance have been inflows into EM mandates of all varieties. EPFR data showed positive flows into EM retail portfolios in hard currency (+$2.6 billion), local currency (+$6.2 billion), and blend funds (+$2.8 billion) during the quarter.

EMFX

While our longer-term, positive view on EMFX remains, the Q2 outlook for EM currencies is uncertain due to unanswered questions pertaining to the evolution of U.S. trade policy, particularly towards China. The U.S. Trade Representative (USTR) investigation into China's intellectual property practices will be particularly important to watch. It is expected that the USTR investigation will make affirmative findings and remedy recommendations (tariffs, sanctions etc.) before but no later than August 2018. It is also currently uncertain whether trade friction will escalate via retaliatory actions by affected countries on which the U.S. has imposed and may impose tariffs in the future (see the Global Economic Outlook section for additional detail). The potential for U.S. protectionism to spread—and for retaliatory actions by affected countries—will risk the current favorable and solid global growth backdrop that EM currencies have benefitted from over the last two years. On the positive side, to date, the Trump Administration's trade rhetoric has been more bellicose than its actions. Our base case is for U.S. trade policy to continue to lack material substance, at least for the better part of 2018, as the risks from escalation to economic growth and financial markets are likely too great of a concern for the Trump administration heading into the fall mid-term elections.

Should our U.S. trade policy base case prove too optimistic, EM currencies may experience weakness. However, we believe that any selloff would likely be short lived as the big, longer-term picture for EM currencies is bright. **First, investors will likely seek to continue to diversify out of the U.S. dollar as the U.S. (under a volatile Trump administration) becomes more isolated in the global economic and political sphere. Second, the U.S. dollar will likely continue to be plagued by: a) the U.S.' twin deficits (particularly the weak fiscal stance); and b) the U.S. economy being a late cycle economy while many DM and EM economies are beginning or mid cycle. Third, EM currencies are relatively cheap (by real effective exchange rates), the U.S. dollar is overvalued, real rates are very attractive in a number of EM economies, and EM current account positions have improved materially over the past four years and are forecast to remain at manageable levels.** Investment capital will likely continue to shun the U.S. in favor of other DM and EM economies.

Outside of trade risks, investors are also concerned about the impact rising U.S. interest rates will have on EM currencies. However, despite the U.S. being one of the worst performing government fixed income markets this year, many EM currencies have appreciated. We think that concerns over rising U.S. interest rates are overblown as long as inflation remains stable and around the Fed's target, as it has been during this cycle. We acknowledge the risk of higher inflation, but it is not our base case that it will accelerate significantly enough to force the Fed to change the pace of their hiking cycle from their current one hike per quarter. Gradual Fed tightening amid a stable global growth and benign inflation backdrop has proven to be a good environment for EM currencies historically, and we think it will remain so going forward.

Going Forward

Despite the tepid performance at the end of the first quarter, our relatively optimistic outlook for EM fixed income remains intact. PGIM Fixed Income's economics group is looking through the recent softness in economic data and remains positive on the outlook for both DM and EM growth for the remainder of 2018. Global investment and trade continue to expand smartly, and loose U.S. fiscal policy should be stimulative for the medium term (although it may cause difficulty toward the end of the cycle). We expect the rhetoric around trade wars will eventually tone down, as all sides realize that a trade war would be disastrous for all involved. **EM inflation across most countries is contained, and many countries are relatively early in their growth cycles vs. the U.S. and Europe—Brazil, Argentina, and Russia are expected to grow 2-3% in 2018 after just exiting recessions in 2017, for example**. **And valuations continue to be supportive; the first quarter selloff in hard currency spreads and currencies has increased what we believed were already attractive levels.**

OUTLOOK: Positive. While the EMD sector could face short-term volatility from a number of uncertainties, i.e. mounting trade tensions, we continue to see opportunities across the sector as encouraging fundamentals pair with relatively attractive valuations after the volatility in Q1.

Municipal Bonds

In Q1 2018, AAA-rated municipal bonds underperformed U.S. Treasuries with maturities of five years and longer. The 30-year Municipal/Treasury yield ratio increased to 99.3% from 92.7% by end of Q1. Despite total new issuance of only $63 billion, a 32% drop vs. the prior year, elevated dealer inventories and steady selling from bank portfolios weighed on the market. Lower corporate tax rates, along with accounting changes, contributed to net selling activity from bank and P&C insurance portfolios in Q1.

AAA municipal yields were higher by 36 bps, 44 bps and 41 bps, in five years, 10 years, and 30 years, respectively, leading to total returns of -1.11% and +0.58% for the high grade and high yield indices, respectively. High yield munis were boosted by strong performance from PRASA as Puerto Rico bonds rebounded off the lows. Despite the negative high grade returns and modest high yield returns, municipal mutual funds still experienced $6.5 billion in net inflows in Q1.

Long taxable municipal total returns were -1.92% in Q1, outperforming the long U.S. corporate index. Excess returns for long taxable municipals of 64 bps also outpaced those of the long corporate index for Q1.

A major focus for the market in the coming months will be the U.S. Supreme Court decision in Janus v. AFSCME, which is expected by end of Q2. Recall that the case 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 vs. 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. This would be viewed favorably by the market given the expectation that union/government bargaining discussions would likely be more constructive. However, we would not expect a favorable decision to provide a quick fix for certain states and localities struggling with significant pension and OPEB liabilities.

On the credit front, several states are experiencing year-over-year growth in revenues due to tax reform related factors. While this is a near-term positive, we do not view this as a change in the credit trajectory for lower-rated states like Illinois (Baa3 negative/BBB-/BBB negative) and New Jersey (A3/A-/A), among others.

Despite the bounce off the lows for the majority of Puerto Rico bonds, the situation remains tenuous with ultimate bondholder recoveries uncertain. As we've highlighted in the past, we do not expect that events in Puerto Rico will impact the broader municipal market.

Our positive outlook for Q2 is driven by the expectation that technicals will turn more favorable as negative net supply becomes more pronounced. In addition, higher yields vs. the beginning of Q1 provide a more attractive entry point for investors. A range bound interest rate environment should be supportive of continued mutual fund flows. Taxable municipals will likely perform in line with corporate bonds, with potential for outperformance should corporate M&A activity pick up.

OUTLOOK: Positive. Favorable technicals in Q2 should lead to solid outperformance vs. Treasuries.

NOTES

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

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PGIMJ201804090378