3rd QUARTER OUTLOOK

PGIM FIXED INCOME

July 2018

The Global Fixed Income Business of Prudential Financial, Inc.
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Of Flowers and Flesh Wounds

After a half year of ongoing global uncertainty, investors continue to find varied—and perhaps mixed—metaphors to explain the evolving fixed income landscape.

- This edition of PGIM Fixed Income's Quarterly Outlook opens with **"Q2 Showers to Bring More Rain or Flowers?"** (click title to view) by Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds. Tipp looks at short-term factors that may be supporting the U.S. dollar, the recent divergence in developed market rates, and how conditions might unfold in the spread sectors over the second half of 2018.

- In **"'It's Only a Flesh Wound'—The Global Expansion Continues,"** Nathan Sheets, PhD., Chief Economist and Head of Global Macroeconomic Research, and the PGIM Fixed Income economics team cover some of the concerns that may have dented investors' enthusiasm in recent months. Despite concerns about global trade skirmishes, declining central bank liquidity, and pockets of EM volatility, they find that support for the ongoing economic expansion largely remains intact.

- One of the uncertainties facing the emerging markets sector has come from the political front, and in **"What Elections in Select EM Countries Are Telling Us,"** our macroeconomics and EM portfolio management teams analyze the recent political results in Turkey and Mexico, while setting the stage for the upcoming Brazilian elections in October 2018.

- Finally, **click here to register for our upcoming Quarterly Webinar** on July 18th, 2018 when Arvind Rajan, PhD., Head of Global and Macro, will join Tipp and Sheets in discussing our investment outlook.

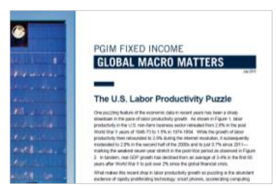
Recent Thought Leadership on PGIMFIXEDINCOME.com (Click Title or Image to View)

The Case for Global Bonds

How Clean is "Clean"? Greece is Aiming for a "Clean Exit" from its Third Bailout

What to Watch as the ECB's QE Nears an End

The U.S. Labor Productivity Puzzle



Mexico's Peje-nomic Outlook

And Coming Soon: *China's Bond Market Opening—Crossing the River by Feeling the Stones*

Sector Views

Developed Market Rates (page 11, click to view): We're maintaining tactical positioning across several developed rate markets as they appear to be trading in tight ranges. We're also implementing some later-cycle trades, such as a "curve cap" in the U.S.

Agency MBS (page 11): Neutral vs. rates, while remaining underweight vs. other spread products. Prefer up-in-coupon positioning in both 30- and 15-year sectors to maximize carry. Still holders of seasoned pools given better prepayment behavior and better convexity.

Structured Products (page 12): Long-term positive on structured products at the top-of-the-capital structure, especially CLOs and CMBS, although spreads could widen modestly in the short run before stabilizing. We remain content to earn carry at current spreads. Negative on conduit CMBS mezzanine tranches as credit quality is unimpressive. Increasingly looking at financing trades, rather than exposure to underlying assets, amid tight spreads and high leverage demand.

IG Corporate Debt (page 13): Cautious given increased downside risks even with wider spread levels, favorable fundamentals, and earnings growth momentum. Still favor U.S. money center banks. U.S. tax reform remains supportive.

Global Leveraged Finance (page 15): Neutral on U.S. high yield as solid fundamentals and favorable technicals appear to be nearly priced in. Slightly more constructive on U.S. leveraged loans compared to U.S. high yield over the next 12 months, primarily due to greater downside protection. Moderately positive on European leveraged finance based on expectations for spreads to tighten modestly in the short and medium term with support from solid fundamentals, earnings growth, and decent European macro conditions.

Emerging Market Debt (page 17): Constructive. EM policymakers have responded credibly to the recent market volatility, and hard currency assets have historically performed well during Fed hiking cycles and global market shocks. Local rates also appear to have overshot in many instances and present select opportunities. While USD strength could continue, focusing on EMFX relative value—rather than the direction of the USD—may be the prudent strategy in the short run.

Municipal Bonds (page 18): Positive. Favorable technicals in Q3 could lead to outperformance vs. Treasuries.

Q2 Showers to Bring More Rain or Flowers?

The markets struggled in Q2 as the fears on the trade and political fronts that emerged early in the year were realized in the quarter to varying degrees, while the long shadow of quantitative tightening continued to stretch across the markets (see the Global Economics section for details). The trade conflicts started getting awkward at the G20, but then became real as U.S. barbs were met with tit-for-tat measures that are at risk of intensifying as Q3 begins. The results from the Italian elections in Q1 transformed into a market nightmare in Q2 as renegade parties entered a coalition with a platform that appeared to jeopardize Italy's finances and its relationship with Europe. Meanwhile, emerging market developments, including elections in Turkey and Mexico, raised concerns about the potential rise in policy heterodoxy (see the Global Economics section).

Over the first half of 2018, these concerns fueled a continued widening of spreads from the tights of Q1, which may have gotten a bit ahead of fundamentals. However, after months of widening, spread product may offer reasonably good value. Fundamental and political risks may still loom, but in many cases, these may be more than priced in.

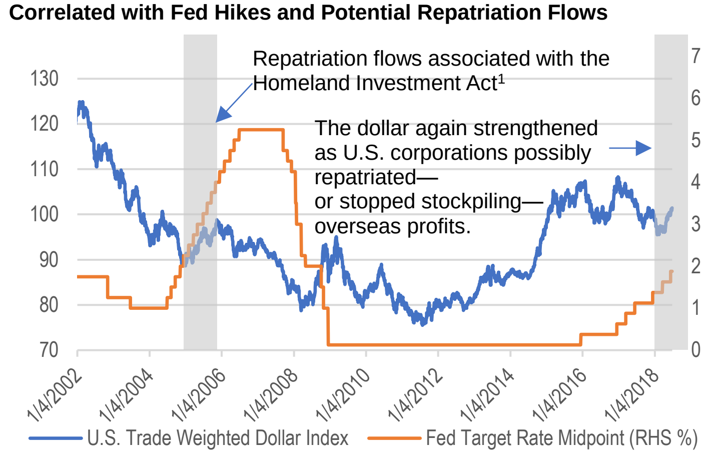
	Total Return (%)				
Multi-Sector	**Q2 2018**	**YTD 2018**	**2017**	**2016**	**2015**
Yen Aggregate	0.22	0.60	0.18	3.0	1.1
Global Agg. Hedged	0.19	0.07	3.04	4.0	1.0
U.S. Aggregate	-0.16	-1.62	3.54	2.7	0.6
Euro Aggregate	-0.47	0.26	0.68	3.3	1.0
Global Aggregate	-2.78	-1.46	7.39	2.1	-3.2
Individual Sectors	**Q2 2018**	**YTD 2018**	**2017**	**2016**	**2015**
U.S. High Yield Bonds	1.00	0.08	7.48	17.5	-4.6
Municipal Bonds	0.87	-0.25	5.45	0.3	3.3
U.S. Leveraged Loans	0.78	2.38	4.09	9.9	-0.4
Mortgage-Backed (Agency)	0.24	-0.95	2.47	1.7	1.5
U.S. Treasuries	0.10	-1.08	2.31	1.0	0.8
CMBS	-0.06	-1.38	3.35	3.3	1.0
European Leveraged Loans	-0.07	0.67	3.72	7.0	3.6
European IG Corporate	-0.25	-0.64	2.41	4.7	-0.6
U.S. IG Corporate Bonds	-0.98	-3.27	6.42	6.1	-0.7
European High Yield Bonds	-1.03	-1.48	6.79	10.8	1.3
U.S. Long IG Corporates	-2.83	-6.77	12.09	11.0	-4.6
EM Local (Hedged)	-2.84	-1.29	3.68	4.7	-2.2
EM Debt Hard Currency	-3.54	-5.23	10.26	10.2	1.2
EM Currencies	-5.78	-3.41	11.54	3.5	-7.6

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures. All investments involve risk, including possible loss of capital. Sources: Bloomberg Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Senior Secured Loans (Credit Suisse). Performance is for representative indices as of June 30, 2018. See Notice for full index names. An investment cannot be made directly in an index.

Stronger Dollar: Temporary Bounce or New Trend?

One distinct change in Q2 was the course of the dollar. After a year of weakness, the dollar changed course, appreciating versus both EM and DM currencies during the quarter. While much of the impetus may have come from a general "flight to quality" against a backdrop of weak spread markets, trade fears, and the ongoing Fed rate hiking cycle, another, albeit minor, contributor may have been the change in the U.S. tax code. Having lost their incentives to keep profits offshore, U.S. corporations may have repatriated—or at least stopped stockpiling—overseas profits. While much of the profits abroad were already likely in dollars (but simply offshore), a fraction may have been changed back to dollars. Perhaps just as important, or even more so, this dynamic stemmed the rollover and growth of money market and short-term bond portfolios and instead diverted monies toward debt reduction and share repurchases—which may have contributed to the outperformance of U.S. equities. More relevant for the dollar, the reduction in short-term investments likely supported the rise in LIBOR, which may have contributed to the bounce in the dollar. At any rate, if the rise in the dollar was in fact related to a direct or indirect one-time offshoot of the tax change, the downtrend that started early in 2017 may resume as the impact diminishes, and the U.S. twin deficits remerge as dominant negative drivers for the dollar.

Figure 1. Strength in the Trade-Weighted Dollar Index Often Appears Correlated with Fed Hikes and Potential Repatriation Flows

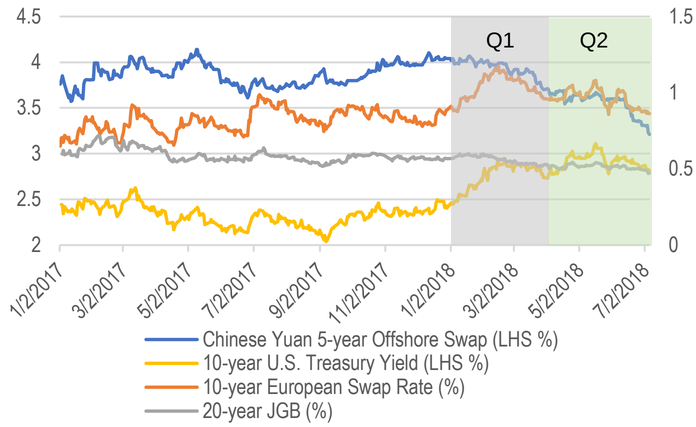


Source: Bloomberg as of June 2018. [1]Often referred to as the "The Homeland Investment Act," the measure was part of The American Jobs Creation Act of 2004 HR 4520.

Rate Markets: Outside of the U.S., Markets Rally

On the rates front, the U.S. diverged. With inflation at target, unemployment down, and the Fed continuing its cautious rate-hiking cycle, U.S. long-term yields finished the quarter relatively unchanged while remaining higher year-to-date. In contrast, the ECB emphasized the downside risks in the economy, primarily stemming from trade, thus indicating the likely need for low rates through the summer of 2019. Similarly, the BoJ signaled easy policy for the long haul as it delayed and lowered its expected path for rising inflation. In line with the central banks' reading, long rates in Japan and Europe ended Q2 at their lows for the year. Elsewhere, Chinese rates rallied substantially with yields falling to three-year lows as policy eased in an effort to support growth (see the following box on index inclusion).

Figure 2. While U.S. Treasury Yields Remain Higher YTD, Other Benchmark Yields Generally Declined Since February

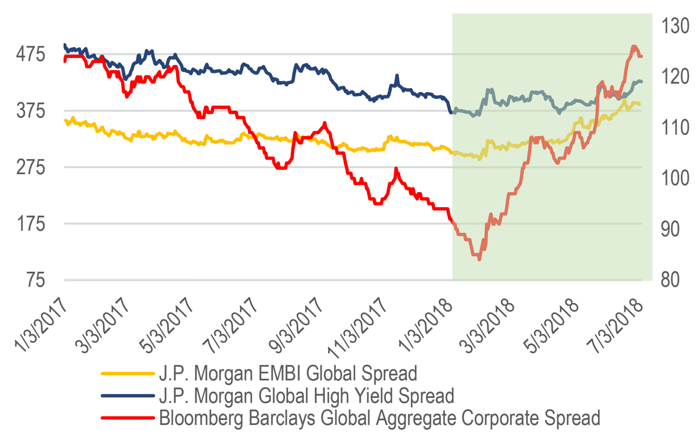


Source: Bloomberg as of July 2018

What's Next? Summer Meltdown or Meltup?

With scorching summer heat sweeping across the U.S. and parts of Europe, this summer started with the feel of a literal meltdown. Yet, as previously noted, spread market valuations may be reasonable in light of the recent repricing observed in Figure 3. While one could fear the worst on the fundamental and policy fronts—particularly given the recent trade skirmishes—we feel a solid "lose-lose" large scale trade war offering only losses for consumers, producers, and most incumbent politicians remains unlikely. Other areas of stress that seemed at a breaking point in Q2—e.g. Italian politics, immigration issues pan-Europe etc.—may have also passed their peak stress points, opening the possibility of a summer meltup in valuations, or at least a summer of consolidation followed by a fall harvest.

Figure 3. Spread Market Repricing Continued in Q2

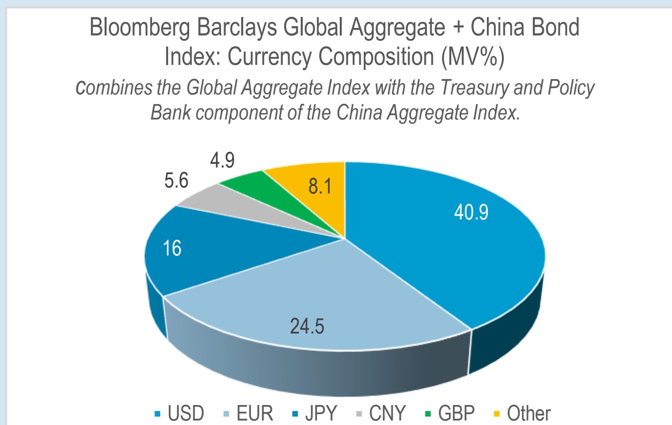


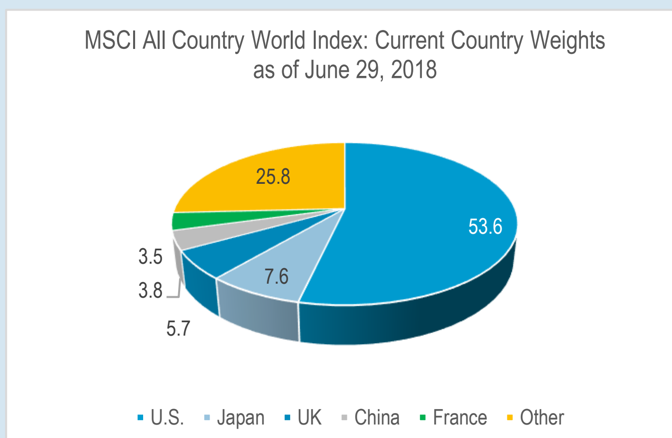
Source: Bloomberg as of July 2018

While some would counter that, even with the recent spread widening, spreads are still closer to historical tights than their wides, the fact remains that this cycle could extend well beyond the average length thanks to heightened regulation and central banks' caution in tightening conditions. Furthermore, given the continued low government yields in many markets, at some point, the search for raw yield may drive spreads narrower once again.

Chinese Markets Entering the Global Stage

China, arguably the world's most influential country in terms of its contribution to growth, will pass an important milestone as it pertains to the financial markets with next year's expected inclusion into one of the most followed global bond indices, the Bloomberg Barclays Global Aggregate Index. Similar to the present situation in equities, the inclusion will be limited, not entering at its full market capitalization weighting, but instead following a 20-month phase-in process that will include only government bonds and a few government-sponsored banks. Even with this narrow inclusion, it will account for about 5.6% of the index as its fourth largest currency component, as indicated below. Given the large and rapidly growing size of the Chinese economy and its financial markets, the inclusion of China into the global indices should bring significant diversification to the global bond indices over the coming decade (for additional details on China's impending bond index inclusion, visit PGIMFixedIncome.com for the upcoming white paper: *China's Bond Market Opening—Crossing the River by Feeling the Stones)*.

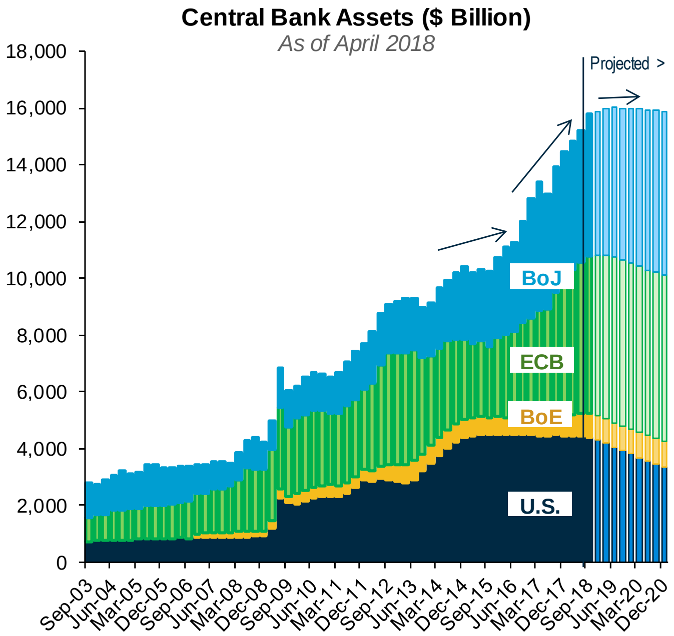




Source: Bloomberg Barclays Indices and MSCI as of March 2018 and June 2018, respectively.

On the other hand, risks abound. Despite the dovish stances of the ECB and BoJ, they are importantly reducing their asset purchases. At the same time, there is the significant "crowding out" in the U.S. with the Fed set to accelerate its portfolio roll-off in both Q3 and then again in Q4 as U.S. Treasury borrowing continues to grow, drawing liquidity away from riskier assets and into U.S. Treasuries. How much of the increase in market volatility, widening of spreads, and hesitation in the equity markets is due to tightening liquidity conditions?

Figure 4. QTs Set to Continue and Intensify with the Fed's Roll-off and Increased U.S. Treasury Issuance, While the ECB and BoJ Stand Poised to Reduce Their Purchases



Source: Bloomberg and Haver Analytics. Source of projections: PGIM Fixed Income. As of April 2018. There is no guarantee that the projections shown will be achieved.

So, we'll have to wait and see. While it may be too early to hope for this summer, especially considering the typically cautious seasonal patterns, fundamentals would seem to support of some reversion in G3 rates—U.S. stabilizing or moving a bit lower relative to Japanese and European long rates—and a stabilization, if not a reversal, in spread markets as well as a resumption of the weaker dollar trend.

The Bottom Line: Longer-term fundamentals argue for a weaker dollar and relative long-rate stability. In light of the recent selloff, spread market valuations may offer good value, especially given the continued low yields on global government bonds. But thanks to ongoing sources of volatility, primarily in the political and policy realms, it is difficult to call the timing of a spread market rally.

"It's Only a Flesh Wound"—The Global Expansion Continues

In our Outlook a few months ago, we emphasized that the global economy and financial markets were being supported by strong macro fundamentals. These fundamentals included broad-based global growth, surprisingly low and stable inflation, and solid business confidence and investment. Global growth was thus projected to remain solid, but still below the pace seen in previous expansions. In our judgment, this narrative remains largely intact. But there has been no shortage of worrisome news in recent months:

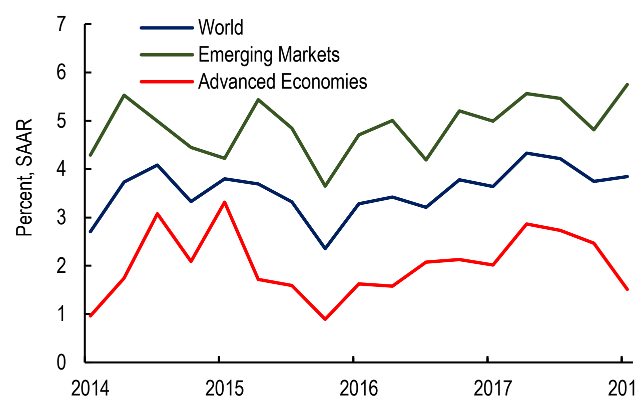
- The Trump Administration has been more confrontational in its trade policies than we had anticipated. And it's not clear where or when this is going to end.
- The performance of the euro-area economy has been softer than we expected. We dismissed a Q1 slowdown as stemming from extraordinary factors like unfavorable weather and a severe flu season, but the subsequent rebound has been uninspiring (see the following Euro Area section for more).
- The political situation in Italy, while avoiding worst-case scenarios, has evolved in a less favorable way than we expected with more acute political and policy risks (e.g., of unsustainable fiscal easing). Political risks also loom large in Mexico and Brazil.
- Oil prices have moved up to their highest levels since late 2014. They have been lifted by concerns about Iranian production as President Trump withdrew from the JCPOA[1] and by continued strong oil demand (in line with an overall solid pace of global activity).
- The Federal Reserve has continued to gradually hike rates, in the context of a strong U.S. economy (more in the following U.S. section), but the Fed's communication has been somewhat more forceful regarding the need for further rate hikes than markets had anticipated. This, in turn, has helped fuel a 5% appreciation of the dollar over the past three months.
- Taken together, the overall environment has become less supportive of the emerging markets. To date, severe stresses have been limited to Argentina and Turkey—two countries where fundamentals have been relatively soft. But, in response, both countries have taken strong remedial actions (See the EM section as well as the EM Elections page and the EM Sector Outlook for more).

But we have also seen some signals that are more favorable or, at least, that have mixed implications. Perhaps most striking, the U.S. economy has manifested considerable momentum. This has reflected the economy's generally favorable and balanced fundamentals as well as the Administration's fiscal stimulus. The U.S. economy thus looks strong through the end of next year. Thereafter, however, the quantum of stimulus falls off sharply, suggesting risks to growth in 2020. Former Fed Chair Ben Bernanke described this as a "Wile E. Coyote" moment.

Meanwhile, the performance of the Chinese economy has been mixed. The authorities have moved to tighten credit policies in recent months, focusing on reining in credit extension in the shadow banking sector. But our appraisal is that Chinese leaders have little appetite for growth to fall appreciably from current levels, and they have recently taken monetary and other policy actions to support growth.

All told, indicators of global growth have recently softened a touch, but they generally remain in solid, expansionary territory. Some Q1 slowing of GDP growth in the advanced economies was offset by stronger performance in the emerging markets.

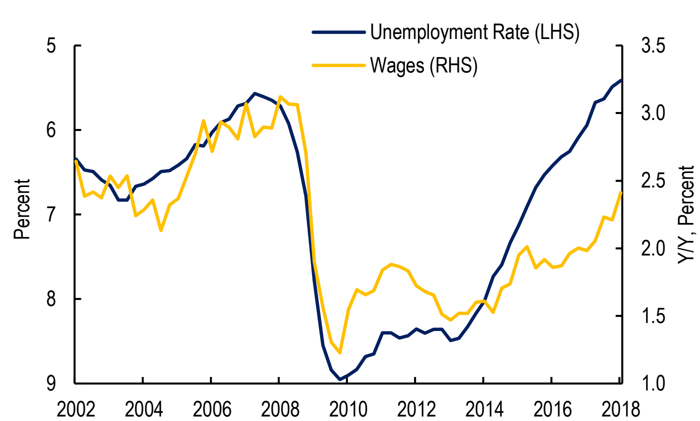
Figure 1. Real GDP Growth (Q/Q, %, AR)



Source: Haver Analytics as of June 2018

In addition, PMIs through May remained firm. Also, despite remarkable tightness in some DM labor markets, wage growth has been well contained, which should allow central banks' policy normalization plans to remain gradual.

Figure 2. Advanced Economies Unemployment Rate (Inverted) and Wage Growth (%)



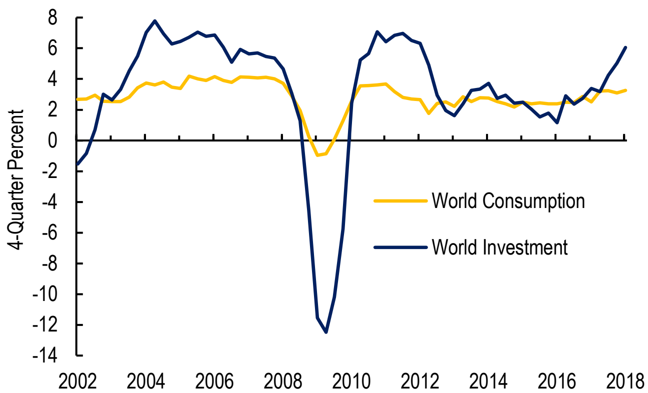
Source: Haver Analytics as of June 2018

Given the thrust of these developments, our baseline expectations for solid growth in the global economy remain broadly intact. We

[1] *JCPOA refers to the Joint Comprehensive Plan of Action as it pertains to Iran.*

see global growth as likely to continue at a pace just a notch below that recorded at the end of last year with the data suggesting that there is still considerable momentum in global consumption and investment. Activity in the advanced economies should pick-up through the rest of the year relative to the pace in Q1, but growth will likely cool some in the EM economies. At the same time, we expect that global inflation will remain subdued, rising only gradually as the expansion proceeds; this, in turn, will allow central banks to maintain their gradual pace.

Figure 3. Real Consumption and Investment Growth (4-Quarter, %)



Source: Haver Analytics as of June 2018

Nevertheless, the downside risks surrounding our assessment are now more acute than a few months ago. As before, we remain skeptical that the U.S. President will take steps to noticeably impede U.S. or global growth, which would strike us as both bad economics and bad politics. However, our confidence bands on this issue are increasingly wide. Our sense is that the stresses in EM to date have been more about investors "kicking the tires" on EM exposures, in the face of rising U.S. policy rates, than a wholesale and sustained retreat.

Recent developments have also highlighted that the broad-based global expansion that we observed during much of last year did not mean that countries were necessarily at identical positions in their business cycles. This is an important observation, especially when assessing the global central banks. Although the Fed is hiking with increased determination, monetary policy elsewhere has often been hesitant to follow suit (see the following sections on Japan and the Euro Area) with important implications for financial markets this year. Finally, we continue to highlight that our still relatively favorable near-term outlook is bracketed by some significant longer-term challenges related to deteriorating global demographics, lackluster productivity performance, and high indebtedness levels (in the public sector in the United States, Japan, and some euro-area countries, and in the private sector in China). These long-term challenges, if unaddressed, will likely become more virulent over time and, as markets begin to price them into the outlook, may weigh on performance sooner than many investors now expect.

The remainder of this essay covers the global regions in more detail.

United States

After taking a breather in Q1, the U.S. economy rebounded sharply in Q2, with GDP growth now tracking in the 3.5%-4.0% range. Consumer spending is likely to top 3.5% in Q2, after a lackluster 1.0% pace the previous quarter. Household tax cuts and strong job growth, which has averaged 207,000 per month this year (up from 182,000 last year), are supporting the acceleration. Business investment remains solid, given the favorable demand backdrop and the recent business tax cuts. Net exports are also rebounding, and Congress' budget deal is lifting government spending as well.

U.S. inflation has now reached the Fed's 2% target, give or take. But upside inflation pressures remain muted. Wage growth continues to run at a moderate pace. Household credit growth slowed to a 3.3% annualized pace in Q1 '18, and household indebtedness remains high. All of this suggests pricing power may still be limited for many industries. Given stronger growth and slightly firmer inflation, we expect the Fed to hike a total of four times this year, followed by a couple more hikes next year, but the risks around this assessment are likely tilted to the downside. Other relatively dovish DM central banks, elevated global trade tensions, and increased EM risks have contributed to the dollar's rise since mid-April, which has, in turn, reinforced the effects of the Fed's monetary tightening.

Heavy Treasury bill issuance and tax law changes that diminished incentives for U.S. corporates to hold cash overseas have put upward pressure on money market rates, including the effective Fed funds rate, creating challenges for the Fed in keeping the funds rate within the targeted band. Hence, the Fed raised the Interest Rate on Excess Reserves (IOER) by only 20 bps in June. We view this as a technical adjustment designed to help keep the Fed funds rate within its band. But these developments have kicked off a broader discussion as to how much the Fed's balance sheet reduction efforts are contributing to the tightening of financial conditions.

Euro Area

The euro area's economic expansion continues, but we see mounting signs of slowing in the hitherto rapid momentum. The euro-area wide manufacturing PMI in June posted its sixth consecutive decline, and manufacturing order books have peaked. Besides several temporary factors that held back growth in Q1, important structural bottlenecks are emerging. Capacity utilization is nearing its all-time high and labor shortages are starting to bite, especially in Germany where unemployment has fallen to a new post-unification low. Against this backdrop, we downgraded our growth forecast for this year by 0.3 percentage points to 2.0%, and now view the risks to the outlook as skewed to the downside.

Inflation seems to have troughed in Q1. Headline rates have been rising, in part owing to higher energy prices. Underlying price pressures are also firming gradually; core inflation reached 1.3% yoy in May. In this context, the ECB has begun normalizing its monetary policy. In line with our expectations, the central bank decided to extend its asset purchases (APs) beyond September but halt them altogether by year-end. In a dovish twist, it revised its forward guidance, suggesting policy rates will remain unchanged at least through the summer of next year. Moreover, the ECB made it clear that it can resume its APs as needed.

Political risks have intensified. International trade tensions have ratcheted up further, including a recent U.S. threat to impose tariffs on EU car exports. In addition, the Europe-wide controversy about migration has caught up with Chancellor Merkel and, for the first time, her tenure has become a topic of speculation. A leadership change at this juncture would likely further dim prospects for meaningful EU reforms. Last, but not least, the newly formed government in Italy may yet decide to pursue large-scale fiscal stimulus, which would set it on a risky collision course with its European partners.

Japan

Following eight uninterrupted quarters of positive real GDP growth, including growth well above trend through most of 2017, Japan's economy unexpectedly contracted slightly in Q1. Temporary factors weakened consumer spending, residential construction, and business inventories earlier this year. However, a rebound since then has been underway as manufacturing reaccelerated this spring and retail sales picked up. Even so, the weak start to the year led us to mark down our 2018 GDP estimate to 1.2% from 1.4% previously.

Further downside risk includes the possibility of escalated trade tensions involving the U.S. and Japan's trading partners. But labor market developments continue to be a bright spot in the recovery, with the unemployment rate falling to 2.2% in May. Participation rates among female and older workers continue to climb, and the government has adopted plans for admitting another 0.5 million foreign workers over the next seven years.

Given the unexpectedly soft economic data at the start of the year and ongoing weakness in core inflation (still well below the 2% target), the BoJ laid to rest speculation that it would move to lift its yield curve target any time soon. The yen consequently weakened, providing modest reflation support going forward. But yen appreciation remains a risk given the ongoing geopolitical strains and global trade tensions.

China

We expect the Chinese authorities' policy tightening to be dialed back somewhat as headwinds to growth are becoming more formidable. Until recently, favorable export growth, resurging property activities, and solid profit margins have provided a conducive environment for the authorities' "de-risking" efforts. But headwinds may now be gathering for growth going forward. First, while export growth across Asia has surprised to the upside, rising trade tensions could imperil future buoyancy. Second, an ongoing improvement in corporate margins implied by the difference between PPI and CPI seems to be abating. Third, local government finances have recently benefited from brisk financing via land sales, but the central government has previously moved to curtail such activity. In addition, the regulatory de-risking initiative has recently resulted in defaults—though they are still at a comparatively low level—while incipient signs of more subdued investment and consumption momentum have gathered.

Against this background, we expect the authorities to ease off the pace of de-risking, notably via further RRR (reserve requirement ratio) cuts and liquidity injections and by making greater use of exchange rate flexibility. In addition, while some efforts to incentivize and facilitate institutional investors' access to the onshore bond market are likely after the one-year anniversary of the Bond Connect program, we expect capital controls to generally remain tight. In all, we see Chinese growth this year coming in a little below the government's 6.5% target and slowing somewhat further next year.

Emerging and Frontier Markets

Tighter global financial conditions and rising protectionism have rendered the backdrop more challenging for emerging and frontier markets. Notably, those economies with deeper fundamental vulnerabilities, particularly external vulnerabilities, have been under the most pressure. This list includes Argentina, Ecuador, and Turkey. The situation in South Africa has also become more difficult of late as the honeymoon with President Ramaphosa is now over. The new government faces a difficult wage negotiation for public sector and state owned enterprise (SOE) employees. Moreover, the deterioration in the terms of trade and the impact of the U.S.-China trade dispute do not bode well for the economy in the near term.

Going forward, we expect authorities to intensify their efforts to restore confidence and stabilize financial conditions, but these countries' underlying fragilities complicate this re-anchoring. In the case of Argentina, fiscal and monetary policies could be further tightened to bolster the credibility of fiscal consolidation efforts, rein in unfavorable inflation dynamics, and reduce the pressures on the economy's external imbalances. Ecuador, on the other hand, may advance its engagement with the multilaterals, particularly the IMF. The country's cabinet was overhauled to enhance the credibility of the macroeconomic framework and to improve the business environment. In South Africa, we expect the market-friendly new Mining Charter to support confidence, while the authorities complete budget-friendly public-sector wage negotiations.

Markets have also focused on idiosyncratic developments in several EM countries that have comparatively stronger fundamentals, such as Brazil and Mexico (see the following section on EM Elections). In Russia, President Putin was comfortably re-elected, as expected, and is planning to boost the economy via an ambitious infrastructure program. Even so, government finances should be on sound footing as the VAT rate will be increased in 2019 and pension reform, which will significantly raise the retirement age, will be gradually implemented.

What Elections in Select EM Countries Are Telling Us

We knew going into 2018 that the EM election calendar would weigh on markets, which has clearly been the case in select countries, such as Turkey, Mexico, and Brazil. The dynamic behind these actual or eventual election results—and the respective market implications—requires ongoing context amid a global backdrop of tighter liquidity from G3 central banks and a less certain global trade outlook. It is an environment where headlines and short-term market moves can distract from the potential opportunities brought by political change and current valuations.

Turkey—June 24, 2018

The elections in Turkey were a source of volatility during the first half of 2018 given the lack of credibility of the country's macro framework and concerns about President Erdogan's power reach under the new constitution. President Erdogan won the election in the first round, but will rely on a coalition in Parliament, so somewhat of a check remains. The market was focusing on the country's economic vulnerabilities and policy credibility. While Erdogan has a strong command over the conservative electorate, the election results indicate that the economy and its trajectory matters to the electorate more broadly.

From a macroeconomic perspective, one of the key issues is whether post-election Turkey returns to fiscal rectitude. The government's estimate of potential output growth is 5.5%—some 2 percentage points above more realistic estimates. As growth decelerates, this may invite further stimulus and, as a result, could usher in a further deterioration of credit fundamentals. Rising inflation and a widening current account deficit are clear symptoms of overheating. This calls for tighter macro policies in order to curtail domestic demand. Although the central bank raised its benchmark policy rate to 17.75%, it remains to be seen whether the resulting real policy rate of about 5% is sufficient to stem the pressure on the Turkish lira, given apparent political meddling in monetary policy, rising inflation expectations, and high external financing requirements.

Despite the poor policy choices and vulnerabilities in Turkey, especially from the private sector external funding needs, the sovereign balance sheet is strong enough that we don't see a credit event for sovereign debt. The risk comes from potential contingent liabilities from the banking sector whereby policymakers keep pushing for growth levels that are above potential as credit fundamentals continue to gradually weaken. That said, we think there is value in Turkish spreads. We are more cautious on the Turkish currency and local bonds.

Mexico—July 1, 2018

Mexico's general election resulted in the victory of left-wing populist candidate Andres Manuel Lopez Obrador (AMLO) and a substantial shift to the left for Congress. Why the shift to the left? The narrative of AMLO is underpinned by his effective articulation of grievances stemming from Mexico's systemic corruption, security concerns, and economic malaise of the last four years. AMLO is a grass roots politician who has remained in the public scene for a long time—this was his third Presidential race. While AMLO's policy rhetoric and campaign promises could pose risks to Mexico's fundamental outlook, the combination of a relatively sound economic starting position, institutional safeguards, pragmatism, and market discipline will likely prevent any material deterioration of the macroeconomic fundamentals in the short term.

However, the cumulative impact of a series of microeconomic distortions that may be implemented over the tenure of the incoming administration could challenge Mexico over the longer term. Investor's will need to parse out the noise from potential degradation of the institutional underpinning of Mexico's orthodox policy framework. The outlook for NAFTA remains uncertain, caught up in bigger trade rifts and the U.S. trade agenda. This poses a risk, but Mexico could make adjustments so as to avoid a sustained fundamental deterioration.

For now, there is ample opportunity in fixed income assets, and a limited recovery occurred in the weeks leading up the election. Given the hawkish tone of the central bank, local bonds in Mexico do not reflect any rate cuts. We think that in a scenario where the outlook for global growth and trade does not denigrate materially from here, interest rates in Mexico could decline. Credit spreads on Mexican corporate and quasi-sovereign assets represent good relative value given the selloff. Finally, the Mexican peso is attractive from a longer-term valuation perspective.

Brazil—October 7, 2018

(The potential exists for a second round of elections on October 28th, if necessary)

The political landscape remains highly uncertain ahead of the general elections scheduled for October. We are still in the early stages of the race, in which the potential roster of candidates changes continuously, so polls need to be heavily discounted. Another key uncertainty is the extent to which structural features of Brazil's electoral system favors mainstream parties/candidates and will offset the anti-establishment sentiment that could bolster the prospects of heterodox outsiders. While a number of the candidates in the lead can be described as "populist," we do not think it is the best depiction of what the voter wants—the electorate has not discernably shifted to the left. However, voter dissatisfaction with established political parties and frustration at what is perceived to be the corrupt political class is clear. Also, the significant middle class is discontent with "quality of life" and the security situation.

The markets were holding up going into Q2, but the more challenging global backdrop, worsened by a trucker's strike in May, provided the catalyst for the broader selloff. The strike was initiated in response to higher fuel prices and led to a partial reversal of an earlier decision allowing Petrobras to independently rely on market determined pricing. The market did not like this reversal and consequently punished Petrobras, Brazilian equities, and other financial assets. Moreover, growth forecasts have been revised downwards. However, there was more to the story. Brazilians by and large supported the strike, even though it shut down major cities for parts of May, as it underscored the frustration with government policy.

Since the election will not take place until October and will likely go to a second round, the picture remains uncertain. Brazil specific factors, along with risk aversion more broadly, have already led to a big selloff in local bonds and the currency. The market is testing the central bank, but, for now, BACEN does not feel the need to hike rates along with other EM central banks. Brazil's external position is more resilient—reserves are high, and the amount of sovereign external debt is very low. Almost all candidates support pension reform, which is key to stabilizing local debt dynamics. We think there is value in hard currency sovereign and quasi-sovereign bonds as well as local bonds. We are more tactical on the currency given the prevailing sentiment, though the strong balance of payments position is a positive factor over longer horizons.

Developed Market Rates

Our developed market rates outlook for Q3 combines nuanced adjustments to a few of our existing positions with some later-cycle trades.

At the outset of Q2, we anticipated a trading range on the U.S. 10-year yield between 2.65% and 2.95% with Treasuries poised to outperform derivatives (both futures and interest-rate swaps). While the 10-year trading range was slightly higher at 2.75% to 3.10%, cash Treasuries outperformed swaps as spreads at the intermediate and long portions of the curve widened during the quarter. Looking ahead, given the potential for further changes to the interest in excess reserves rate (IOER) toward the lower end of the Federal Reserve's rate corridor, Treasury funding rates should trade lower in tandem, thus richening Treasuries relative to fixed-rate derivatives.

Overall, we'll likely add duration when the 10-year yield approaches the top of the recent trading range of 2.75%-3.00%, while potentially shedding duration when the yield moves toward the bottom of the range. More specifically, we're maintaining long positioning in the seven-year portion of the U.S. curve and short positioning at the front of the curve. We believe the market continues to underprice future Fed tightening given that our base case calls for a total of four Fed Funds hikes in 2018 (i.e. two more hikes in the second half of the year) and two additional hikes in 2019.

Although the term premia across the U.S. cash curve remains relatively low (modeled at about 7 bps), we remain wary of underweighting the back of the Treasuries curve given the strong technical bid from pensions and other entities seeking to match long-term liabilities.

While we don't anticipate an imminent turn in the U.S. economic cycle, we've recently implemented a late-cycle "curve cap" trade consisting of three-year options on the 2-10 swaps curve. The trade is essentially positioned for a steeper swaps curve within three years should the Fed find it necessary to cut the Fed Funds rate, likely leading to steeper curves across the complex. We're also maintaining a Eurodollar steepener trade.

In Europe, we expected the 10-year bund yield to remain capped at 75 bps in Q2, and it subsequently traded in a range of 25 bps to 64 bps during the quarter. The ECB followed through with its expected announcement that it would end to its quantitative easing program by the end of 2018, yet it also pledged not to raise rates before the summer of 2019, which added a dovish tilt to its announcement.

In contrast to the U.S. cash curve, the 5-30s bunds curve steepened by about 20 bps in Q2 and maintains a relatively steep term premium (modeled at about 17 bps). Given that backdrop, we're positioned for a flatter 5-30s bund curve going forward.

In Japan, we anticipated the 10-year JGB yield would remain anchored in a range of 0 to +10 bps in Q2 given the BoJ's yield curve control policy, and the yield traded in a narrow band of +2 bps to +6 bps during the quarter. Looking ahead, we don't anticipate a change in the yield curve control policy, and we continue to expect the 10-year yield to remain in a narrow trading range.

OUTLOOK: We're maintaining tactical positioning across several developed rate markets as they appear to be trading in tight ranges. We're also implementing some later-cycle trades, such as a "curve cap" in the U.S.

Agency MBS

Reminiscent of Q1, the agency MBS sector cheapened relative to U.S. interest rates on the back of unsettled risk markets, higher implied volatility, a continued reduction in Fed purchases, and lack of dollar-roll performance. Following a solid start to the quarter, with the sector posting excess returns vs. Treasuries of +18 bps in April, pressure on the agency MBS market paved the way for two consecutive months of nearly flat excess returns, which trimmed the Q2 excess return to +15 bps. For the year, excess returns vs. Treasuries ended Q2 at -24 bps. Seasoned vintages outperformed due to housing turnover causing faster prepayments for discount-priced bonds and dealer inventory replacement needs as yields continued to climb.

Commercial banks became more aggressive in allocating to agency mortgages during the quarter as rates backed up. Banks added approximately $25 billion of MBS (on a net basis), which excludes Wells Fargo, whose assets are still capped under February's Federal Reserve Consent Order. While rising yields also prompted an increase in investment activity from foreign investors in Q2, it's possible that a boost of confidence towards the sector—resulting from Ginnie Mae's imposing of restrictions on specific originators—may have also been a catalyst. With the Fed's presence in the MBS market continuing to recede, the support for MBS technicals provided by both banks and overseas investors was welcomed.

In the second quarter, prepayment speeds remained contained as primary mortgage rates stayed at the highest levels since 2014—after reaching 2013 peak levels during Q2. Should 30-year primary mortgage rates remain around 4.625% or higher, prepayments are expected to remain benign. With a weighted average coupon of 3.54% and an average dollar price just over $100, less than 10% of the MBS universe is an economic candidate for refinancing at this point.

Ginnie Mae prepayment speeds remained elevated relative to Fannie Mae/Freddie Mac which once again led to underperformance during the second quarter. As mentioned above, Ginnie Mae took action against some fast originators, suspending their participation in the multi-issuer program until action is taken to demonstrate behavior more in line with cohort speeds. In general, we believe that a slowing of Ginnie Mae prepayment speeds will continue to benefit the sector as a whole.

Looking ahead, the performance of agency MBS could stand to benefit from dampened seasonal origination activity (driven by elevated primary mortgage rates), subdued prepayment expectations through the fall, stability amid the extension of model durations, and limited convexity hedging. Net supply running below estimates, a generally underweight buyer base, along with the potential for continued demand from banks, REITs and overseas buyers as rates hover around 3%, should also provide support to MBS spreads.

Further increases in the Fed's reinvestment cap—to $16 billion in Q3—will likely result in an increase in net supply for the market to absorb and lackluster performance from dollar rolls (lower coupons are currently trading flat vs. one-month LIBOR), which give us reason to exercise some degree of caution as we move through the remainder of the year.

OUTLOOK: We are neutral vs. rates, while remaining underweight vs. other spread products. We prefer up-in-coupon positioning in both 30- and 15-year sectors to maximize carry relative to the index. We remain holders of seasoned pools given better prepayment behavior and better convexity.

Structured Products

The second quarter was challenging as spreads widened for some of our overweights within structured products: Conduit CMBS AAAs were wider +5 bps QTD and +10 bps YTD, while CLO AAAs were +7 bps QTD and unchanged YTD. Furthermore, our up-in-capital-structure bias, at best, kept pace with riskier structured product cashflows. Several factors contributed to this effect: 1) structured product funds generally have higher return targets, which creates a "bid" for down-the-capital-structure tranches, 2) technicals were heavy in seniors due to robust new issue supply coupled with still onerous regulatory hurdles for expanded bank balance sheet participation, and 3) fundamentals remain fairly strong, giving support to risk taking down in the capital structure. Despite the underwhelming relative performance of up-in-capital-structure positions, and the possibility of further near-term softness, we maintain our preference for higher-quality tranches as we believe these bonds have superior carry to many other high-quality spread products and should outperform riskier tranches in a market downturn due to significant structural protections. Our favorite positions within structured products remain AAA CLO and CMBS.

Non-Agency RMBS: Despite a weak quarter for spreads generally, legacy RMBS bucked the widening trend by tightening modestly. And, while legacy '06/'07 seniors remain particularly well supported by improving technicals (paydowns are 10-15% annually on outstanding stock), we are neutral on this sector as we believe the technical bid has surpassed the fundamental value. At LIBOR +75-95 bps, other sectors offer similar value without the valuation challenges posed by these legacy assets (e.g., realization on default and recovery assumptions). Fannie/Freddie credit risk transfer spreads were unchanged to modestly tighter. While this sector is largely fundamentally sound, despite deterioration in recent vintages (e.g., higher percentage of high debt-to-income mortgages), we believe spreads are too tight compared to the structural leverage of the tranches. We believe the sector is maintaining artificially tight levels in part due to the availability of repo financing. Re-performing loans (RPL) is one area that is seeing fairly robust supply with banks, Fannie/Freddie, and HUD continuing to divest themselves of these loans. This supply has in turn put pressure on the RPL resecuritization market, with spreads widening 20 bps from the mid-quarter tights. We like the fundamentals of this asset class although extension risk is a consideration and at least partly to blame for the widening. With spreads hovering around Swaps +80 bps for 3-4 year AAA risk we feel RPLs offer a compelling risk/reward proposition despite the technical headwind. Away from the U.S., we maintain our neutral stance on UK RMBS. Spreads were range-bound, with non-conforming seniors at 3m £L+60-65 bps and 4+ year 2nd pay classes trading at 3m £L+100-110 bps. A cooling UK housing market, consumer affordability concerns, and Brexit-related uncertainty remain potential headwinds for the market. Opportunities in peripheral non-performing loan securitizations are increasing as Spain and Italy make progress in cleaning up bank balance sheets. We are more constructive on Spanish opportunities due to Spain's better economic momentum and more certain legal framework.

CMBS: As we commented in our last quarterly outlook, we expressed modest concern AAA CMBS spreads could widen, which they did in Q2. AAA conduit spreads were mostly flat throughout the quarter, but leaked wider in the latter part of June, which we ascribe to new issue supply. Spreads started the quarter at S+ 85 bps and finished at S+90 bps. Similarly, CMBS agency spreads widened during the quarter from S+48 to S+55 bps, and single asset/single borrower floating rate spreads widened from LIBOR + 70 to L+80 bps. Conduit issuance was light in April and May before increasing toward the end of June. Nonetheless, Q2 issuance of $10 billion was down from $12 billion in Q2 '17 and about the same as Q1 '18. Moreover, 2018 issuance is projected to be about 10% lower than the $70-$75 billion previously forecast for private label CMBS. While lower issuance is usually a positive technical for spreads, we remain concerned spreads could widen in the near term on overall market conditions. We view any spread weakness as an opportunity to add to positions, and continue to advocate a position in AAA CMBS and agency CMBS, both of which offer compelling long-term value for high-quality bonds. Our advocacy of CMBS does not extend to mezzanine tranches, a theme maintained from prior quarters, due to low levels of credit enhancement and unimpressive underwriting standards. That said, on the run BBB- CMBX tightened 25 to +435 bps, while cash was unchanged at S+325 bps. On fundamentals, commercial real estate (CRE) values were up 1.3% in Q2 '18 and are now 23.2% above the previous peak ('07). Major markets have been the outperformers, while retail and suburban office have continued pockets of weakness. We would not be surprised if CRE values soften if cap rates increase with interest rates, though somewhat wide cap spread premiums could offer a cushion to soften the blow. Occupancies and rents continue to slowly improve, perhaps with the exception of the multi-family sector due to high levels of new construction.

CLO: Many of our key themes persist from prior quarters, notably, we remain constructive on AAA and AA tranches and continue to consider these bonds to be among the cheapest bonds in the fixed income universe on a risk-adjusted basis. Senior CLOs benefit from significant credit enhancement and industry diversification across the underlying senior secured loans backing the bonds. We are more cautious further down the capital structure given that current valuations do not reflect the potential downside performance 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 and a benign default environment will continue due to strong corporate balance sheets. We expect AAA/AA spreads may widen early in Q3 due to high supply before they resume tightening as there is significant global demand for high-quality bonds, and in the U.S., the prospects of higher LIBOR will likely entice yield seekers. U.S. AAA/AA spreads are now between 3mL+ 105-115 and 150-180 bps, respectively. In Europe, AAA spreads are 3mEuribor+90-97 bps (including the Euribor Floor). We expect robust issuance across primary, resets and refinancings. We believe reset and refinancing activity will continue in Q3 as 2016 vintage CLOs exit non-call periods in the U.S. and Europe. This increase in issuance should dampen spread compression. We believe the market will continue to see positive net issuance of at least $60 billion through year end (we expect a record breaking year of gross issuance) as positive net supply in underlying bank loans is also very robust at about $75 billion year-to-date with over $150 billion expected. We continue to remain focused on the effects of the widening in the cross-currency basis as many global investors may shift demand for certain bonds as the costs or benefits of hedging change.

ABS: Consumer fundamentals remain healthy, despite some marginal softening of credit quality. For example, against a strong economic environment categorized by low unemployment, auto loan defaults have been increasing due to weaker underwriting by some lenders. That said, more established auto lenders have tightened their standards since early 2017, which should translate into securitized collateral quality mitigants for recent vintage paper. Similarly, credit card loss rates have inched up recently, albeit from very low levels. Nonetheless, we will repeat from last quarter, we do not believe established consumers lenders have been exploring, en masse, the speculative universe of consumer credits. ABS spreads were unchanged to slightly wider in Q2 ‘18. Three-year senior cards are L+17bps (+1 Q-o-Q), two-year senior autos L+20 (+5), three-year senior consumer loan L+65 (unchanged), and five-year senior refinance private student loan L+65 (unchanged). New issuance is currently at $126 billion YTD, now 7% ahead of last year’s pace (and, full-year 2017 was $222 billion—a post credit-crisis high). Demand was weaker for benchmark sectors, such as cards, autos, floorplan, and equipment, and was characterized by lighter new issue order books vs. the beginning of year and lower secondary interest (balance sheet funding makes vanilla ABS a negative carry proposition for many dealers). Demand for senior and subordinate securities that trade wide of L+100 has remained stable due to a general lack of supply for this cohort. We also note that the basis between senior and mezzanine tranches is compressed. As such, we have a stronger up-in-quality bias. We remain constructive on select securitizations from originators of unsecured consumer loans, subprime auto, and refinanced private student loans that address our ESG considerations, including income-verified underwriting, and that display robust structural features. We continue to be cautious with online marketplace lenders due to unproven and shifting business strategies and regulatory ambiguity.

OUTLOOK: Long-term positive on structured products at the top-of-the-capital structure, especially CLOs and CMBS, although spreads could widen modestly in the short run before stabilizing. We remain content to earn carry at current spreads. Negative on conduit CMBS mezzanine tranches as credit quality is unimpressive. Increasingly looking at financing trades, rather than exposure to underlying assets, amid tight spreads and high leverage demand.

U.S. and European Corporate Bonds

Investment grade corporate bonds struggled in Q2 as the Federal Reserve’s drive to raise interest rates and concerns over trade wars, global growth, and a strengthening U.S. dollar weighed on market sentiment. U.S. corporate bond spreads widened by 14 bps during the three months and posted an excess return of -100 bps to similar-maturity U.S. Treasuries. European corporate bond spreads also widened in response to signs of slowing economic growth across the region, uncertainty over the European Central Bank’s tapering program, prospective trade tariffs, and political upheaval in Italy.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q2	YTD	Q2	YTD	6/30/2018
U.S. Corps.	-0.98	-3.27	+14	+30	123
European Corps	-0.25	-0.64	+27	+36	122

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures. All investments involve risk, including possible loss of capital. 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 June 30, 2018. An investment cannot be made directly in an index.

U.S. Corporate Bonds

As in Q1, sentiment in the investment grade corporate bond market remained mixed with strong fundamentals and generally healthy technicals overshadowed by fears of tighter Fed and ECB monetary policies, trade wars, and political uncertainty.

On the fundamental side, stronger U.S. economic growth and tailwinds from tax reform helped lift corporate earnings and revenues, which are forecast to rise by 19% and nearly 9%, respectively, in Q2. Profit margins are strong, corporate liquidity is ample, and lower tax rates and foreign cash repatriation are cashflow positive. Leverage remains elevated but has improved in some issuers due to higher profit margins. Credit improvement continues to be noteworthy in the commodity sectors. Other issuers, primarily those taking on extra debt to fund mega mergers & acquisitions, such as AT&T, were downgraded.

In the new issue market, activity picked up during the quarter with an increase in longer-term maturities amid a flatter yield curve. As expected in a high business confidence environment, M&A activity and share buybacks rose; M&A deals in excess of $10 billion have become more common, and share buybacks are on track for an annual record ($650 billion).

Investor demand also remained healthy with most new issues oversubscribed. Non-U.S. investor demand declined somewhat, due in part to currency hedging costs, although they continue to reinvest into longer-maturity and lower-quality issues. In addition, U.S. pension contributions have increased. 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.

Against this backdrop, we look for individual security selection across industries, credit quality, and maturities to be a key driver of returns going forward. 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, are well capitalized, and offer ample liquidity. In fact, all 35 major U.S. banks passed the Federal Reserve's annual stress test in June despite harsher scenarios. The second half of the test, which evaluates capital levels and the banks' plans for capital returns (buybacks, dividends and capital issuance), was generally positive, paving the way for shareholder payouts. However, the Fed did object to the plans of the American division of (Germany's) Deutsche Bank, citing weak capital planning. In addition, the Fed gave conditional approval to Goldman Sachs, Morgan Stanley, and State Street to return capital to shareholders after their plans breached minimum stress levels, signaling a reversal in the hawkishness of the regulatory environment.

We continue to find value in post-event new issues as well as select pharmaceuticals, energy, and "U.S.-centric" issuers. We are looking to add select European banks due to stabilizing fundamentals and wider spread levels and still favor taxable municipal bonds and BBB-rated corporates.

European Corporate Bonds

European corporate bonds also struggled in Q2 in anticipation of the ECB's tapering announcement and increased political volatility, particularly in Italy. Euro corporate spreads rose by 28 bps in the month of May alone before tightening a degree in June following the ECB's announcement. The ECB affirmed it would end its corporate bond purchase program by year-end 2018 (provided inflationary developments remain favorable) and would not raise rates before next summer—a move welcomed by the markets. Further spreading tightening, however, has been hampered by fears over trade and tariffs. In contrast, the sterling investment grade market was fairly resilient, outperforming both the EUR and USD markets as GBP spreads widened a mere 6 bps in Q2.

Fundamentally, credit quality remains healthy, but has probably peaked for this cycle. And while European economic data (ex-UK) has been solid, the pace of growth has decidedly slowed. M&A activity is beginning to pick up, but remains well below U.S. levels. Issuance has been reasonably strong so far this year, albeit below 2017 levels, especially in the corporate new issue market; financial new issuance is still reasonably robust.

In European portfolios, we trimmed risk earlier in the year but are now looking to selectively add back risk in light of recent spread widening and more attractively-priced new issues. Some new deals are providing concessions of up to 30 bps. We remain overweight banks, insurance, and non-core REITS. We continue to hold an overweight in non-euro and non-ECB eligible issuers, although on a smaller scale given the significant spread compression in these segments.

In global corporate portfolios, we hold a neutral stance on both EUR and USD exposure, owing to the recent underperformance in both currencies. We reduced GBP risk as sterling spreads have significantly outperformed and trimmed exposure to companies with potential tail risks 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 favor strong and "post-event" BBBs over single-A rated corporates that are potential large M&A candidates and/or have more shareholder-friendly boards. We continue to take advantage of price dislocations and yield discrepancies between EUR and USD bonds of the same and/or similar issuers.

In both the U.S. and Europe, we believe the recent back-up in spreads may provide long-term opportunities, especially in the primary and "post-event" markets, but are taking a cautious approach in the near term. Downside risks include more aggressive than expected central bank tightening, uncertainties over global trade policies, regional and global geopolitical risks (including Italy), Brexit, the upcoming search for ECB President Mario Draghi's successor, and, over the longer-term, China's contribution to global growth.

OUTLOOK: Cautious given increased downside risks even with wider spread levels, favorable fundamentals, and earnings growth momentum. Still favor U.S. money center banks. U.S. tax reform remains supportive.

Global Leveraged Finance

After some mixed results early on, the U.S. high yield market steadied as the second quarter progressed, posting solid results as most other fixed income sectors retreated. In Europe, the high yield market began Q2 on solid footing before weakening in the face of rising volatility.

	Total Return (%)		Spread Change (bps)		OAS/DM (bps)
	Q2	YTD	Q2	YTD	6/30/2018
U.S. High Yield	+1.00	+0.08	-1	+8	371
Euro High Yield	-1.03	-1.48	+74	+105	399
U.S. Leveraged Loans	+0.78	+2.38	-7	-12	345
Euro Leveraged Loans	-0.07	+0.67	0	-3	424

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures. All investments involve risk, including possible loss of capital. Sources: ICE BofAML and Credit Suisse as of June 30, 2018. An investment cannot be made directly in an index. European returns are euro hedged.

U.S. Leveraged Finance

Despite several ongoing macroeconomic concerns, strong earnings growth, minimal default activity, and a subdued new issue calendar, combined with an improving U.S. economic backdrop, provided support to high yield spreads in Q2. Driven by strong underlying fundamentals and lower correlation to rising rates, lower-quality credits continued to outperform. In the second quarter, CCCs were up +3.4% vs. swaps, followed by Bs and BBs at +1.5% and -0.09%, respectively. This brings the CCC return vs. swaps to +4.6% year-to-date, outpacing BBs by 510 bps. In fact, CCCs have now outperformed BBs in nine of the last 10 quarters.

Sector returns were driven more by idiosyncratic events rather than overall sector themes in Q2. The food & drug retail and telecom sectors were the clear outperformers, generating total returns of +4.7% and +3.1%, respectively. Within food & drug retail, the sector received a boost from The Fresh Market, whose bonds bounced several points from distressed levels. Meanwhile in telecom, Sprint was the biggest contributor to outperformance after a merger with T-Mobile was rekindled, which lifted bond prices.

Auto & auto parts distributors was the laggard, posting a total return of -3.4%. Within the sector, the bonds of American Tire saw prices fall more than 80 points following the announcement that Goodyear and Bridgestone plan to form TireHub, a joint venture that will distribute their own products. American Tire will no longer distribute their brands.

Moody's 12-month U.S. speculative grade default rate ended May at 3.7%, down slightly from the 3.9% at the end of Q1. So far this year, the speculative-grade corporate market has seen 43 defaults, with the retail sector recording the most default activity (10), followed closely by the oil and gas sector (9). Looking ahead, Moody's expects the default rate in the U.S. to fall to 2.6%, with low unemployment, tight high yield spreads, and solid economic growth around the world supporting the decline.

High yield bond funds reported outflows totaling $4.7 billion in Q2, and while still in negative territory, the net flows are down considerably from the $19 billion that exited the asset class in the first quarter. We'd note that while 3/4 of the outflows are originating from active managers, a significant portion of the flow volatility has been driven by ETFs, often producing large daily flow volume.

After a slow developing new issue pipeline in Q1, high yield new issuance remained sluggish in the second quarter, with the market pricing 105 deals for $54 billion in proceeds. Year-to-date primary market supply now totals $126 billion, which represents a 28% decline from last year. The slowdown can be attributed primarily to the relatively low levels of M&A activity and a larger portion of issuance migrating to the bank loan market. The energy sector continued to dominate new issuance, accounting for 19% of volume in the second quarter after capturing 27% of activity in Q1.

We are maintaining a neutral view of U.S. high yield overall, as we believe that the solid fundamentals (strong earnings and low defaults) and favorable technicals (limited net supply and persistent institutional demand from Asia) appear to be almost fully priced in. Additionally, we are concerned about the timing of the next recession, which we believe will likely be the key driver of high yield returns over the next 12 months, thereby giving us reason to be less bullish on the asset class.

In general, we expect defaults to remain low for the remainder of 2018 and into 2019, outside of some select sectors. In terms of positioning, we are reducing our overweight to CCCs, as we believe that portion of the credit spectrum is no longer more attractive than other rating categories, particularly single Bs. We remain cautious on commodities and are maintaining an overweight to independent power producers and U.S. consumer-related issuers.

The modest decline in loan prices in Q2 was more than offset by the coupon return. Of note, approximately 20% of loans are now trading above par, down significantly from February's four-year high of 80%.

Year-to-date, the loan index return has outpaced high yield bonds by 209 bps on a total return basis. Lower-rated loans, although only about 5% of the index, also outperformed. For the quarter, CCC-rated loans returned 1.9%, outpacing Bs by 113 bps and BBs by 146 bps.

Flows into loan funds continued in Q2, with the asset class seeing positive flow activity for 19 consecutive weeks during the quarter. On a year-to-date basis, +$11.9 billion has moved into the asset class, adding to the $13.1 billion inflows that we saw in 2017.

Gross new issue volume in the loan space during the second quarter was down relative to 2017's record pace, but remains elevated based on historical averages. The loan market priced 412 issues for $259 billion in proceeds in Q2, which brings year-to-date gross activity to $501 billion. This compares to $577 billion over the same period last year. We'd note that although Q2 2018 gross supply for U.S. leveraged loans is down compared to last year's quarterly pace, Q2 2018 net supply ($91 billion) exceeded Q2 2017's volume ($88 billion).

In 2018, repricings (44%) and refinancings (23%) have accounted for the bulk of the issuance. The technology sector continued its trend from recent quarters, once again leading the way in terms of loan issuance, accounting for 17% of this year's volume. Healthcare and gaming/lodging/leisure were the next biggest contributors, each at 11%. Energy, which is a much smaller component of the loan market, comprised only 3% of this year's new issue supply.

Looking ahead, recent underperformance relative to U.S. high yield makes U.S. leveraged loans appear closer to fair value versus U.S. high yield. And despite weak underwriting standards, we are slightly more constructive on U.S. leveraged loans compared to U.S. high yield over the next 12 months, primarily due to the greater downside protection (higher recovery values) that secured loans provide.

European Leveraged Finance

After a strong start to the second quarter, volatility gripped the European high yield market in May, before giving way to a slow recovery throughout June. After initially widening to a wide of 385 bps during the peak of the selloff sparked by Italian political developments, spreads recovered to end the quarter +39 bps wider at an OAS of 366 bps. At these levels, European high yield spreads are +119 bps wider than post-crisis tights reached in November 2017 (+247 bps).

Single Bs were the clear outperformer in Q2 (+0.41%), as they were the only segment of the European high yield market to post positive total returns for the quarter. The same holds true on a year-to-date basis, with Bs returning +0.52%, compared to CCCs at -0.83%, and BBs at -1.09%.

Primary market activity remained subdued in Q2 with new issue volume trailing last year's pace by 11%. New issue supply has totaled €35.5 billion year-to-date, compared to €45.5 billion over the same period last year. Of the volume, debut issuers have made up €6.9 billion of the primary market supply, compared to €10 billion over the same time last year.

Moody's default rate ended May at 2.5%, a slight increase from the rate of 2.4% at the end of Q1. Looking ahead, several factors remain supportive of our expectations for defaults to remain low over the next 12 months: expectations 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 have outpaced European high yield bonds by almost 200 bps in 2018. We expect the solid demand for European leveraged loans to continue, however concerns about deteriorating underwriting standards are coming into view.

Loan issuance kept pace with last year's levels during the second quarter, albeit with a slight decline. For the quarter, the market priced €23 billion of new issuance, versus the €35.2 billion during the same period last year. The primary market has been dominated by M&A related activity, rather than opportunistic financings (refinancings, repricings, etc.), which declined to €6.7 billion—compared to €17 billion and €34.5 billion in Q1 '18 and Q4 '17, respectively.

Our expectations are for spreads to continue to tighten modestly from current levels in the short and medium term, supported by solid fundamentals, reasonable earnings growth, and a decent macro environment in Europe. Several ongoing macro concerns combined with political uncertainties involving Italy and potential aggressive underwriting resulting from tight spreads and continued demand for leveraged finance products tempers our longer-term outlook. We'd note that our short-term outlook is further supported by a lack of material near-term recession risk in Europe as well as expectations for the ECB to likely take a balanced approach with the pace and intensity of its policy normalization.

In terms of positioning, we favor B-rated issuers and continue to tactically increase our BB allocation through the primary market. We continue to seek out attractive relative value opportunities—created by the uncertain BREXIT outlook for the UK economy—between sterling-denominated and euro-denominated bonds. We also expect loans will continue to outperform bonds in the near term.

OUTLOOK: Neutral on U.S. high yield as solid fundamentals and favorable technicals appear to be nearly priced in. Slightly more constructive on U.S. leveraged loans compared to U.S. high yield over the next 12 months, primarily due to greater downside protection. Moderately positive on European leveraged finance based on expectations for spreads to tighten modestly in the short and medium term with support from solid fundamentals, earnings growth, and decent European macro conditions.

Emerging Market Debt

Following 2017's solid performance, EMD encountered pressure in the first half of 2018 amid rising U.S. Treasury rates, a stronger U.S. dollar, mounting trade concerns, and coalescing idiosyncratic events. EMFX also began a sharp selloff in mid-April in response to capital outflows and weakening growth in Europe and Asia, thus weakening EMFX crosses at the margin. The stronger U.S. dollar stoked fears that countries and/or companies with excessive external borrowing in dollars could be forced to refinance at less favorable exchange rates and/or higher interest rates. Bonds from countries with large fiscal and external deficits, most notably Argentina and Turkey, were particularly sensitive to these developments.

	Total Return (%)		Spread / Yield Change (bps)		OAS (bps)/Yield %
	Q2	YTD	Q2	YTD	6/30/18
EM Hard Currency	-3.54	-5.23	+66	+84	369
EM Local (hedged)	-2.84	-1.29	+59	+45	6.59
EMFX	-5.78	-3.41	+124	+141	4.95
EM Corps.	-1.77	-2.87	+45	+54	325

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The recent EM instability seems to have been aggravated by idiosyncratic stories in Argentina, Turkey, Brazil, and Mexico, as opposed to broad-based weakness across the asset class. And, while these idiosyncratic stories continue to loom over EM for the very short-term, global growth remains on solid ground, shining a more positive light on potential second-half opportunities created by the recent stretch of underperformance. We also note that in the context of country specific concerns (in large part tied to political dynamics, particularly in Turkey, Mexico, and Brazil, which we examine in our EM Election section), policymakers have responded to the feedback from financial markets and have acted accordingly. For example, Argentina's central bank recently implemented a series of rate hikes (1,275 bps) and policy moves in conjunction with finalizing a significant ($50 billion) loan program with the International Monetary Fund and other multilateral lenders (an additional $5.65 billion). During the market turmoil of May and June, Turkey also raised its benchmark interest rate several times; India, Indonesia, and Mexico also raised rates. In Brazil, the central bank decided to increase the use of FX swaps and the Treasury to buy back nominal local bonds in order to provide support and stability to the market. Demonstrating policy credibility and the endorsement of longer-term structural adjustment plans by official creditors should be reasonably positive over the longer term and bolsters our positive outlook for the market.

Hard Currency

Despite periodic volatility and concerns about higher U.S. rates, and/or a strengthening dollar, EM debt has historically performed well during many Fed hiking cycles and countless global market shocks, and we believe this resiliency will eventually emerge from the recent volatility. While Fed hiking cycles and periods of rising interest rates (e.g. 1993-1994, 1998-2000, 2003-2006, 2016-2017) have sometimes resulted in market setbacks, we find that the selloffs have inevitably provided good opportunities to add hard currency exposure. As we consider hard currency spreads in a mid-to-late cycle environment, several positioning themes come to the fore: emphasizing relative value, trading into higher-quality credits for a minimal give up in yield, reducing maturity in flat yield curves and focusing on carry/roll down opportunities, maintaining selective corporate exposure, and holding low cash balances.

Local Bonds

When looking at the local rate markets, the attractive opportunities that we see underscore several of the resilient themes that are prevalent throughout the sector. Our conviction around the Mexican currency and local rates was strong at the beginning of 2017 when Mexico's fundamentals looked good (improving current account deficit, orthodox central bank that placed ex-ante real rates at positive and attractive levels, positive primary surplus), and the risks stemming from the Trump administration potentially walking away from NAFTA were seemingly priced in. Now, NAFTA risks linger and political implementation risks remain after July's general election. Despite these risks, we believe Mexican local assets are sufficiently undervalued (the real effective exchange rate is not much above the lows seen during the "Tequila crisis" of the 1990s, and real rates are near +3%) and view the risk/reward dynamic as skewed to the upside.

We have viewed Indonesia as an attractive local investment since 2013's taper tantrum. Although Indonesia was characterized as a "Fragile Five" country, we took a different view, believing that both the central bank and the government were appropriately addressing the country's macro and micro imbalances. The central bank's recent, welcomed steps to hike rates twice by a total 50 bps addressed the depreciation pressure on the currency that stemmed from broad U.S. dollar strength. With inflation low and real rates relatively high, we see attractive entry points to add value to unhedged Indonesian local rates. The selloff in Brazil's local bonds reflects, in large part, the negative sentiment related to the currency, fiscal conditions, and upcoming elections (also referenced in our EM Elections section). The selloff appears large relative to our expectations of central bank rate hikes over the next year and our fundamental outlook for the country.

EMFX

Despite material USD strength in Q2, particularly against EM currencies, our outlook for EMFX remains cautiously constructive. But given the headwinds, such as tighter USD liquidity and lingering concerns over U.S. trade policy, we think investors will remain selective in allocating capital. Focusing on relative value—rather than the direction of the USD—will likely be the prudent strategy in EMFX in the short run. We come into Q3 2018 with USD strength that could continue given the U.S. growth outperformance, where euro zone data remain on the weak side and several countries in EM, particularly in Latin America, have seen 2018 GDP forecasts revised lower.

U.S. monetary policy appears to be on a steady tightening trajectory (see the Global Economics section for additional details), and the market is now pricing an expanding policy-rate gap between the U.S. and the rest of the developed world for the remainder of 2018. Some EM central banks, fearing inflation pass-through from currency depreciation and continued capital outflows, have tightened monetary policy. Pre-emptive central bank hikes in Indonesia and India surprised the market, while Argentina and Turkey were forced to hike aggressively to stem runs on their currencies. Mexico and Philippines also hiked rates, while Russia curtailed its rate cutting cycle short of most expectations. Overall, more EM central banks are expected to hike rates than cut them over the next 12 months.

Although we're focused on relative value, our cautiously constructive view on EMFX is based on an expectation that global growth will become more synchronized over the remainder of 2018, resulting in the market pricing some monetary policy convergence of select DM countries relative to the U.S. This could bring the current USD rally to an end and, in turn, pull capital out of the U.S. into both DM and EM countries. Non-U.S. DM and EM currencies are now much cheaper than they were at the start of Q2, and many of them present compelling long-term fundamental value. In EM, the real and nominal carry is higher than earlier in the year as some central bank interest-rate hikes have outpaced inflation and may continue to do so going forward. While we wait for non-U.S. growth to stabilize and improve, we're maintaining a relative value focus and will shift stance accordingly and position for a weaker USD if the global growth picture starts improving.

OUTLOOK: Constructive. EM policymakers have responded credibly to the recent market volatility, and hard currency assets have historically performed well during Fed hiking cycles and global market shocks. Local rates also appear to have overshot in many instances and present select opportunities. While USD strength could continue, focusing on EMFX relative value—rather than the direction of the USD—may be the prudent strategy in the short run.

Municipal Bonds

In Q2 2018, AAA-rated municipal bonds outperformed U.S. Treasuries across the yield curve as technicals turned more supportive by quarter end. The 30-year Municipal/Treasury yield ratio dropped to 98.5% from 99.3% in Q2. Year-to-date total issuance reached $164 billion, a 19% decline vs. the prior year. Mutual fund flows were mixed early, before turning positive by end of Q2, bringing YTD net inflows to +$7.1 billion.

AAA municipal yields were lower at the front end of the curve, higher in the intermediate sector, and modestly lower on the long end, leading to Q2 total returns of 0.87% and 3.06% for the high grade and high yield indices, respectively. YTD returns are -0.25% and 3.66% for the high grade and high yield indices, respectively. YTD high yield returns were boosted by strong performance from PRASA as Puerto Rico bonds rebounded off the lows. Long taxable municipal total returns were -0.41% in Q2 and -2.32% YTD, outperforming the long corporate index. Q2 excess returns for long taxable municipals of -38 bps also outpaced those of the long corporate index.

At quarter end, the U.S. Supreme Court handed down a decision in Janus v. AFSCME, overturning a 1977 Supreme Court decision (Abood v Detroit Board of Education), which sanctioned the collection of mandatory agency fees in the public sector. As a result of this decision, public employees who choose not to join a union are not required to pay a fee ("fair share fee") to the union. The expectation is that union membership will decline and the financial strength and power of unions will diminish. The potential exists for more constructive union/government bargaining discussions, which would be viewed positively by market participants. However, we do not expect the decision to provide a quick fix for certain states and localities struggling with significant pension and OPEB liabilities.

Our positive outlook for Q3 is based on extremely favorable near-term technicals and a more attractive entry point for investors following the YTD back-up in rates. Additionally, a relatively stable rate environment should be supportive of steady mutual fund inflows. Continued selling of tax-exempt bonds from bank portfolios could weigh on the market in the second half of the year. The judge overseeing the Puerto Rico bankruptcy is expected to rule on the COFINA sales tax revenue dispute in Q3; however, agents representing the commonwealth and COFINA continue to negotiate a potential settlement. The judge has previously stated her support for a negotiated settlement between the interested parties. We expect taxable municipals to perform in line with corporate bonds, with potential for outperformance should corporate M&A activity persist.

OUTLOOK: Positive. Favorable technicals in Q3 could lead to outperformance vs. Treasuries.

NOTES

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