PGIM FIXED INCOME

QUARTERLY OUTLOOK

JULY 2019

Investment Survival After a Rate Collapse

Thoughts from our Chief Investment Strategist

Seeking Balance in Challenging Cross Currents

Thoughts from our Chief Economist

Fixed Income Overview

While record highs on the major equity indices make for good headlines, the year-to-date returns posted by several fixed income sectors are impressive in their own right. Fueled by the second quarter's collapse in developed market rates, long U.S. corporates (+15.77%), emerging market hard currency debt (+11.31%), long U.S. Treasuries (+10.98%), and U.S. high yield (10.16%) are among the sectors with double-digit returns thus far in 2019. But with many rate complexes at multi-year lows, what should investors anticipate from fixed income going forward?

- In "Investment Survival After a Rate Collapse," Robert Tipp, CFA, Chief Investment Strategist and Head of Global Bonds, separates the prospects into the "bad news" and the "good news." He finds that in a low-growth, low-inflation world, the latter may be the more prevalent force in the coming months and quarters.
- What's keeping the global economy in its current malaise? Nathan Sheets, PhD., Chief Economist and Head of Global Macroeconomic Research, and the Global Macroeconomics Team touch upon the various, regional factors that continue to shape the global economic outlook in "Seeking Balance in Challenging Cross Currents."

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- **Countdown to Zero—The Final Chapters**
- **Frontier Case Study: Ecuador's Path to Economic Sustainability**
- **Credit Research Roundtable**

SECTOR VIEWS

Developed Market Rates | 10

Tactical. Although rate complexes across the G4 collapsed in Q2, the move lower was justified by further moderation in global economic conditions. Therefore, we expect low and rangebound rates in Europe and Japan. U.S. Treasuries—particularly real rates—may see additional support until a catalyst potentially contributes to a short-term correction.

Agency MBS | 10

Positive vs. developed market rates. Nominal and option-adjusted MBS spreads remain at multi-year wides and lagged tightening in other high-quality sectors. Given the decline in primary rates, it may take longer than usual for seasonal supply to stabilize. If the Fed cuts rates, we could see banks increase MBS holdings. We continue to prefer specified pools and to avoid TBA exposure. We favor modest up-in-coupon exposure away from 30-year 3%. We expect to add higher 30-year UMBS coupon exposure later in Q3.

Structured Products | 11

Positive. We remain biased toward top of the capital structure, which offers high risk-adjusted spreads for fundamentally remote credit risk. We generally remain negative on mezzanine structured products and remain mindful that Q3 has historically had meaningful bouts of volatility. Thus, Q2's intra-quarter volatility reaffirms our top-of-the-capital-structure bias amid the ageing credit cycle, slightly deteriorating collateral quality, and flat securitized credit curve.

Corporate Debt | 12

Positive in the near term given favorable fundamentals, healthy technicals, and potential for tighter spreads. We still favor U.S. money center banks. U.S. tax reform remains supportive.

Global Leveraged Finance | 13

Constructive on U.S. high yield, particularly in the belly of the curve, with a preference for Single Bs. We favor the higher-rated portion of the U.S. leveraged loan market. In Europe, we prefer high yield to bank loans.

Emerging Market Debt | 14

Conditionally constructive for spreads, select local bonds, and EMFX—assuming a reasonable outcome to trade negotiations and clearer evidence of growth in China. With the caveat that a supportive backdrop could fail to materialize, there is scope for attractive spread tightening in investment grade and high yield countries and corporates. The outlook for EMFX and rates is less clear, but attractive relative value opportunities remain.

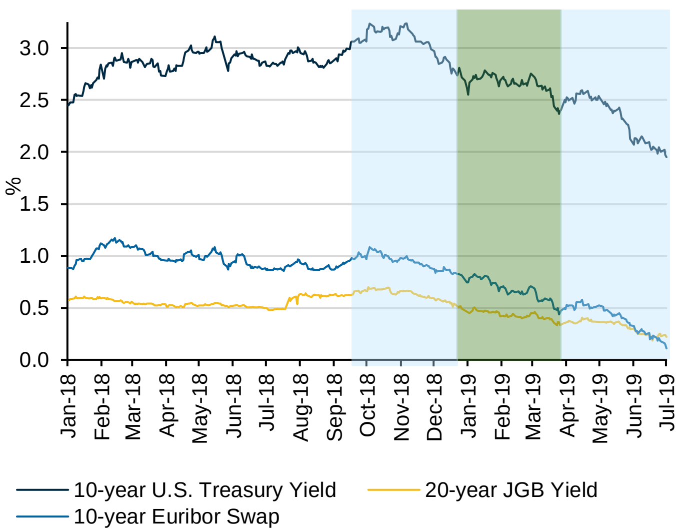
Municipal Bonds | 15

Moderately positive. Strong technical framework and fair valuations should lead to outperformance vs Treasuries.

Investment Survival After a Rate Collapse

The second quarter's collapse in developed market government bond yields seemingly confirmed a trend of mounting economic disappointment where growth and inflation simply remain too low (see the Global Macroeconomics section). As G3 rate markets fell for the third consecutive quarter (see Figure 1) and pointed to the need for more central bank accommodation, the actual tipping points for the institutions varied—the European Central Bank was struck by the market's drop in inflation expectations, while the Federal Reserve and Bank of Japan moved to easing biases as U.S./China trade tensions flared. Although no G3 central bank actually moved, the ECB and the Fed certainly appear poised to act over the balance of the year, if not in Q3.

Figure 1: A Third Consecutive Quarter of Developed Market Rate Declines Left Many Rate Complexes at Multi-year Lows



Source: Bloomberg as of July 3, 2019

While U.S./China trade tensions led to a pronounced hiccup in the risk markets in May, they recovered by quarter end, leaving returns for equities and the riskier fixed income sectors in positive territory and even stronger year-to-date thanks to a banner first quarter (see Figure 2). The return bounty certainly belied what many considered to be low levels of yields and spreads at the beginning of the year.

Figure 2: Long-Term Assets Notched Impressive YTD Returns

(%)

Multi-Sector	Q2 2019	YTD 2019	2018	2017	2016
U.S. Aggregate	3.08	6.11	0.01	3.54	2.7
Euro Aggregate	2.83	5.41	0.41	0.68	3.3
Yen Aggregate	0.91	2.33	0.93	0.18	3.0
Global Agg. Hedged	2.92	6.00	1.76	3.04	4.0
Global Aggregate (USD Unhedged)	3.29	5.57	-1.20	7.39	2.1
Individual FI Sectors	**Q2 2019**	**YTD 2019**	**2018**	**2017**	**2016**
U.S. Long IG Corporates	7.23	15.77	-7.24	12.09	11.0
EM Debt Hard Currency	4.08	11.31	-4.26	10.26	10.2
Long U.S. Treasuries	6.03	10.98	-1.84	8.53	1.3
U.S. High Yield Bonds	2.57	10.16	-2.26	7.48	17.5
U.S. IG Corporate Bonds	4.48	9.85	-2.51	6.42	6.1
European High Yield Bonds	2.38	7.68	-3.35	6.79	10.8
CMBS	3.28	6.62	0.78	3.35	3.3
European IG Corporate	2.16	5.42	-1.25	2.41	4.7
U.S. Leveraged Loans	1.58	5.42	1.14	4.09	9.9
EM Local (Hedged)	3.22	5.26	0.75	3.68	4.7
U.S. Treasuries	3.01	5.18	0.86	2.31	1.0
Municipal Bonds	2.14	5.09	1.28	5.45	0.3
Mortgage-Backed (Agency)	1.96	4.17	0.99	2.47	1.7
EM Currencies	2.07	3.57	-3.33	11.54	3.5
European Leveraged Loans	1.15	2.70	1.25	3.72	7.0
Other Sectors	**Q2 2019**	**YTD 2019**	**2018**	**2017**	**2016**
S&P 500 Index	4.30	18.54	-4.40	21.26	10.6
3-month LIBOR	0.64	1.33	2.23	1.22	0.7
U.S. Dollar	-0.04	-1.19	4.90	-7.85	3.2

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures and full index names. *All investments involve risk, including possible loss of capital. Sources: Bloomberg Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Bank Loans (Credit Suisse). Performance is for representative indices as of June 30, 2019. An investment cannot be made directly in an index.*

The Course Ahead: Volatile, With Opportunities to Add Value

The bad news first. **Lower yields on government debt imply lower expected returns over the long term. Worse yet, thanks to lower rates and longer-dated issuance, the bond market's overall rate sensitivity has increased, boosting the potential for volatility.** If rates enter a secular uptrend, it could be a brutal bear market for bonds.

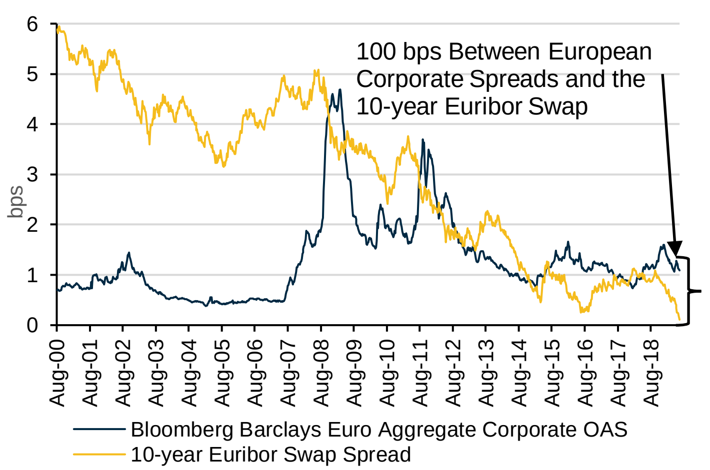
But It May Not Be as Bad as Feared

Now, the good news. **At least in our view, rates seem more likely to remain rangebound around current, or even lower, levels over the long term.** While that idea may seem crazy, the factors covered in our white papers since 2003 that have supported expectations for lower yields—aging demographics, high debt levels, and rising inequality—appear to warrant interest rates at current levels or lower.[1] **After all, despite the low level of rates, growth has continued to moderate, and inflation has remained below target, suggesting that, if anything, rates may not yet be low enough to stabilize the economic trajectory.**

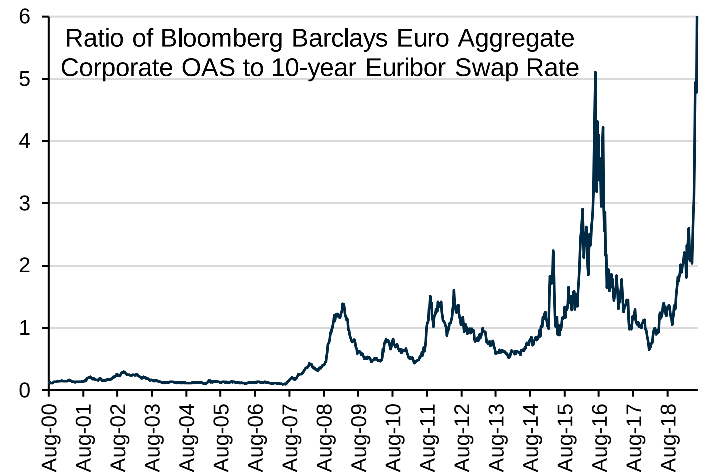
Bonds May Continue to Outperform Cash, Albeit With Significant Volatility

There's more potential good news. Significant opportunities for adding value in the bond market remain. **For one, spreads trade at substantial premiums to underlying yields (see Figures 3 and 4). If and as rates remain low with continuing, slow economic growth, an aggressive search for yield is likely, potentially boosting spread product returns. Furthermore, spreads across various sectors—structured product, emerging market debt, investment grade and high yield corporates, and European peripherals—remain less than perfectly correlated, offering opportunities for sector diversification and rotation.**

Figure 3 and 4: If Corporate Credit Risk Remains Contained, the Spread Between European Corporates and 10-year Swaps Looks Quite Different When Compared to an Underlying Market Yield of 5%, 3%, 1%, or just 11 bps—As is Now the Case. In a Slow-Moving, Low-Yielding World, It's Not Hard to Imagine the Search for Yield Intensifying.



Source: Bloomberg as of June 30, 2019



Source: Bloomberg as of June 30, 2019

Bonds Still for Ballast?

The potential portfolio ballast that fixed income provides may be another positive for the bond market. As low as many government yields seem, they could fall even further if their respective economies worsen. Therefore, bonds may dampen portfolio volatility in a recessionary scenario where the riskier assets, such as equities and real estate, could significantly underperform.[2]

Is That a Tax Hike? Shhh—They Think It's Monetary Accommodation!

Among the list of potential positives for the bond market, we'd note the potential for further policy easing by the BoJ or ECB to inadvertently worsen the economic outlook. While QE and lower rates may help an economy that is a net capital user, such as the U.S., it could have the opposite effect in Europe and Japan, which are net saving/capital providing blocs. If the increased focus on "reversal rates" is any indication, the net effect may simply be an income penalty—or a tax considering that the central banks are taking money via negative yields—on investors, savers, and

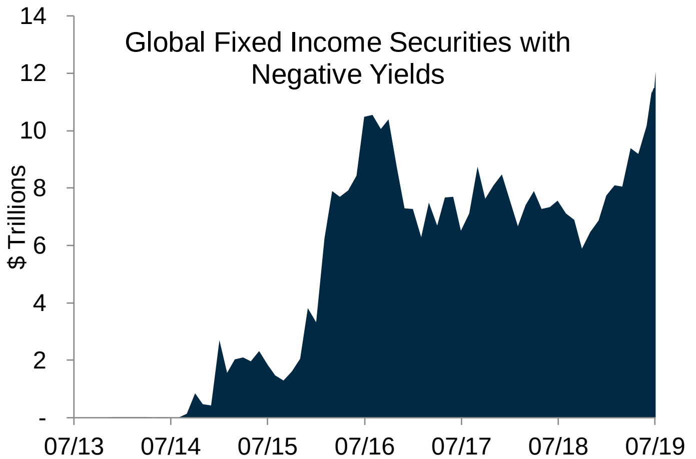
[1] See "Countdown to Zero—The Final Chapters," May 2019; "Lower Range to Drive Stealth Bull Market in Bonds," October 2018; "The Totally Mad World of Low Rates," December 2015; "Europe Into the Void," October 2014; "The Low Ranger," September 2013; "Economic Recovery Creates Opportunities in Bonds," December 2003.

[2] Of course, a "stagflationary" recession where inflation rises as growth slows—as was seen in the heretofore unique case of the 1970s—could create a recession where interest rates rise and bonds act as a drag on portfolio returns rather than a buffer.

financial institutions.[3] After all, negative yields generate revenue for the central banks, which accrues to the benefit of the government. Negative yields on bonds issued by the government may also represent a tax windfall as bond holders pay the government to store their money—i.e., the negative yield, either directly or indirectly, benefits government coffers.

Therefore, more aggressive accommodation from the ECB and/or the BoJ could be doubly positive for the bond market. The first order effects of rate cuts and/or additional bond purchases is simply higher bond prices as short-term rates are cut and longer-term yields are pushed down through asset purchases and forward guidance. A secondary boost to the bond market could come if economic activity is further dampened as the private sector sees its income cut via lower yields or higher taxes (paying higher negative yields on its cash and bond holdings) and observes asset purchases forcibly increasing the amount of money in the system that is subject to negative yields (see Figure 4).

Figure 4: An Expanding Global Universe of Negative Yielding Fixed Income Assets Recently Hit a High-Water Mark of $12 Trillion



Source: BofA Merrill Lynch and ICE Data Indices LLC. Using GFIM Global Bond Index; 1+ year bonds only

Risks Appear More Prominent with Slim Margin for Error

While our base case argues for staying the course in bonds, albeit with lower return expectations, we have to acknowledge the numerous risks on the horizon. One of the more proximate, if not mundane, risks consists of the seasonal tendency for risk-off moves over the lower-liquidity summer months. These conditions could be exacerbated by the U.S. President's penchant for needling countries on critical economic issues via social media. Additionally, with the economic backdrop downshifting, corporations' second-quarter reports could bring an above-average share of cautious guidance, which could subsequently weigh on risk appetite. Alternatively, signs of faster growth—such as June's stronger-than-expected non-farm payroll report—could scupper the market's current expectations for central bank accommodation and quickly lead to a taper-tantrum like bout of rising rates and widening spreads. Again, not our base case, but always best to be on the lookout for detours.

The Bottom Line: True, it's bad that the Q2 collapse in yields lowered the baseline expectation for bond returns. But to the extent that rates remain low and rangebound—thanks to the general backdrop of moderate growth and inflation—bonds seem likely to continue outperforming cash. Furthermore, spreads remain at attractive levels, and the potential for investor confusion and market volatility remains high. As a result, significant opportunities to add value through sector allocation and relative-value trading remain intact.

[3] *Brunnermeier, Markus K. and Koby, Yann, "The Reversal Interest Rate," NBER Working Paper No. 25406, issued December 2018; Fujioka, Toru, "BoJ Member Cites Reversal Rate to Push Back Against Easing Steps," Bloomberg, June 28, 2019.*

Seeking Balance in Challenging Cross Currents

The pace of global economic activity has not yet rebounded from the below-trend readings that emerged in Q4 2018. Intensifying policy uncertainties driven by the ebb and flow of the U.S.-China trade war, but also by a sustained slowdown in global manufacturing and trade, have cast a pall over performance. In response, the Federal Reserve and other major central banks have signaled a more dovish policy stance, which seems to have already provided some support to U.S. activity, and the Chinese authorities are in the process of kicking off another round of stimulus.

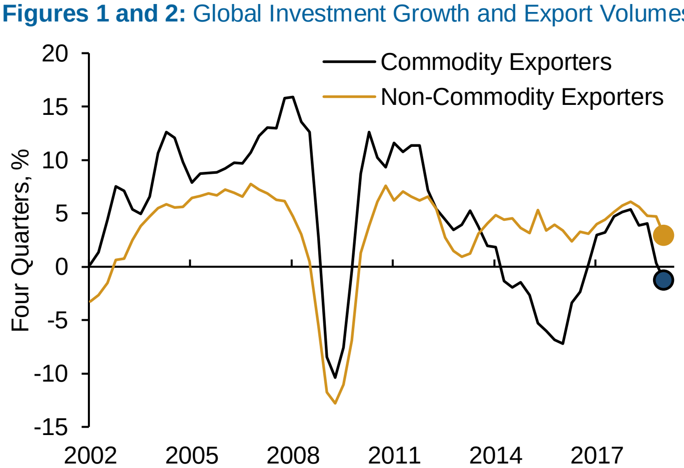
Notably, Presidents Trump and Xi agreed at the G-20 meeting to restart trade talks. A full-blown trade war has been avoided for now, but there is still significant distance between the two countries. We believe that both sides still have incentives to reach an agreement, but the range of possible outcomes remains wide. As such, we see the trade war as an important wildcard for the global outlook.

All told, economic uncertainties remain elevated. **We expect the global expansion to continue but, at least for the next few months, at a lackluster pace as growth struggles to regain its footing.**

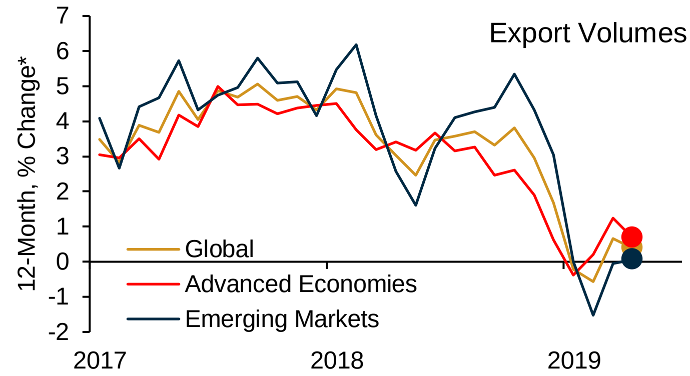
The Macro Data Point to Softening Performance

Global investment showed intensified weakness in Q1, particularly for commodity exporters, and global trade growth declined to near zero (see Figures 1 and 2). In addition, emerging markets saw a broad-based decline in their nominal GDP growth, apparently in line with softer oil prices and global demand. We see these data as indicative of the broader pullback in global manufacturing that has taken hold over the past year. Such headwinds notwithstanding, first-quarter real GDP growth in the U.S. came in a bit over 3%, albeit lifted by rising inventories and a fall-off in imports, and growth in the euro area picked up to 1.6% (SAAR).

Figures 1 and 2: Global Investment Growth and Export Volumes



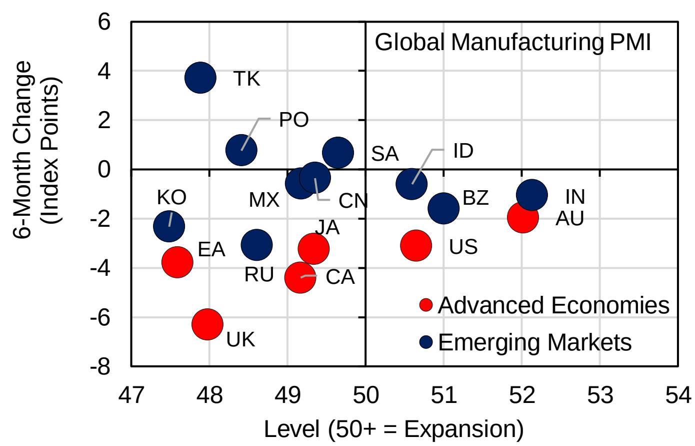
Source: Haver Analytics as of July 2019



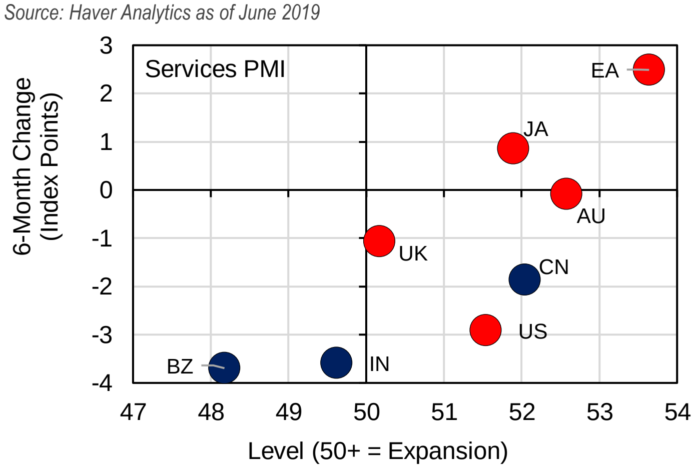
*Source: Have Analytics as of July 2019. *Three-month moving average.*

Our reading is that the relatively soft global performance persisted through Q2. As highlighted by the PMIs in Figures 3 and 4, manufacturing in the advanced economies has sharply decelerated over the past six months, with four of the six major economies posting sub-50 readings. EM manufacturing is doing only a notch better. The performance of the global services sector remains somewhat stronger—most economies remain above 50—but many have weakened over the past six months.

Figures 3 and 4: Global Manufacturing and Services PMIs (June)



Source: Haver Analytics as of June 2019



Source: Haver Analytics as of June 2019

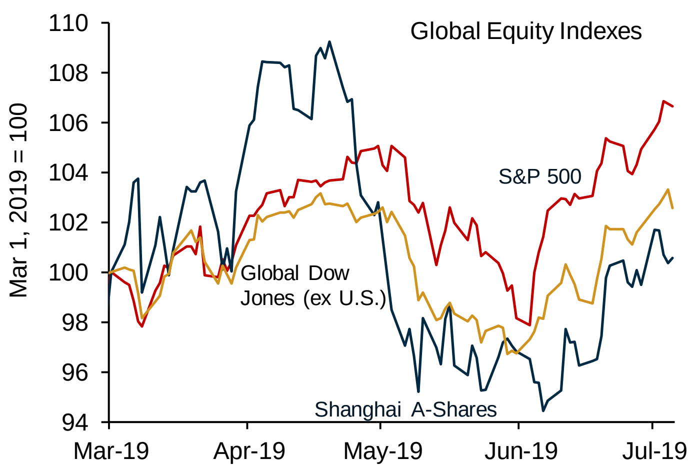
The Trade War has Taken a Bite Out of Sentiment and Left an Imprint on Global Markets

As a related point, Chinese data sagged in May, as sentiment and global markets were battered by the escalating trade war. The U.S. hiked tariffs on $200B of Chinese goods and imposed sanctions on telecom giant Huawei, thus blocking it from obtaining critical inputs from U.S. suppliers. The move against Huawei, in particular, triggered a firestorm of protest in the Chinese press. In response to U.S. actions, China tightened its tariffs on U.S. goods and threatened to cut off exports of rare earth minerals to the U.S.

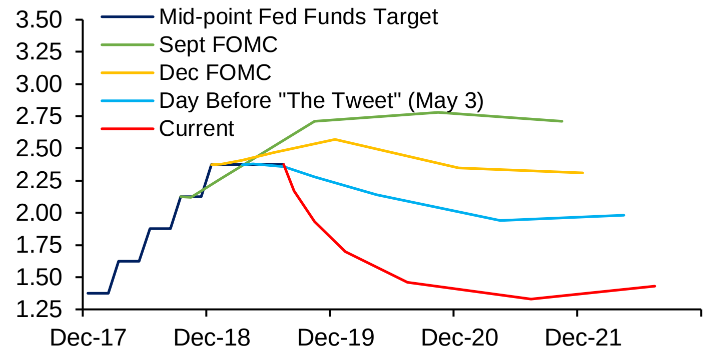
In this context, the agreement in Osaka to restart the trade negotiations is an important step forward. The U.S. will apparently refrain from tariffing the remaining $300B of imports from China and loosen restrictions on Huawei's technology purchases. China, in turn, will increase its purchases of U.S. agricultural goods. The challenges for the negotiators nevertheless remain significant. The two sides must work to re-establish trust. And finding a framework that satisfies U.S. objectives—and that the Chinese leadership views as suitably balanced—will be a heavy lift, but one that we believe will get done.[4]

The ups and downs of the trade war have left an imprint on global financial markets. As the tensions heated up in May, global equity and oil prices declined sharply and EM spreads rose, while 10-year U.S. Treasury yields fell more than 40 bps (see Figure 5). In June, risk markets rebounded sharply as the Fed emphasized its willingness to support the economy, and market expectations for the Fed funds rate continued the precipitous decline that began last fall (see Figure 6). Markets currently envision nearly three Fed rate cuts this year. The trade-related developments in Osaka also supported markets through the second half of June.

Figures 5 and 6: Global Equity Indices and Market Expectations for the Fed Funds Rate**



Source: Haver Analytics as of June 2019



*Source: Bloomberg as of June 2019. **Market implied policy rates the day after the indicated FOMC meeting.*

The Global Economy Continues to Struggle with Broader Challenges

While trade tensions represent the most conspicuous cloud on the horizon, we see other important challenges as well. As the Tories struggle to find a new leader in the aftermath of Theresa May's resignation, Brexit continues to loom as an apparent gordian knot. At the same time, the European Union is grappling with internal politics to name a new leadership team. Beyond Europe, the rising tensions between the U.S. and Iran are amplifying uncertainties in the oil market. And political squabbles about the terms for raising the U.S. debt ceiling continue; if no agreement is reached, the debt ceiling is likely to become binding at some point this fall. Finally, all of this is playing out against the backdrop of deteriorating global demographics, disappointing productivity growth, and rising debt burdens in many countries.

Global investors will have much to fret about as they navigate the difficult cross currents. Nevertheless, these challenges are likely to play out in a broader macro environment of continuing (albeit lackluster) global growth, accommodative monetary policy, and renewed stimulus from China. Global markets have shown remarkable resilience—absorbing the imprint of the ongoing shocks—but not being knocked off balance. **Thus, in our view, the appropriate macroeconomic mindset for the months ahead is one of caution, rather than unalloyed pessimism. We see this choppy environment as likely to bring opportunities as well as challenges.**

The remainder of this essay discusses the performance of the major regions in more detail.

United States: While U.S. GDP grew a robust 3.1% in Q1, half of the growth came from net exports and a buildup of inventories, leaving underlying domestic demand rising at only a 1.6% pace. However, in Q2, domestic demand rebounded. Consumer spending picked up from a 0.9% pace in Q1 to 3.0-4.0% in Q2. Job growth, while having decelerated this year, nonetheless continues

[4] *For more details on the trade war, see our recent summary, "The Trade War—Yet Another Chapter."*

to outstrip its long-run potential pace, while the unemployment rate remains near all-time lows, supporting the pickup in consumer spending. Business capex appears to be growing at a moderate pace, and the housing market, after a year-long slowdown, is finally showing signs of life now that mortgage rates have moved back down. The end of the government shutdown in Q1 has put federal government spending on track to provide a modest fiscal boost over the next couple of quarters. **We thus continue to expect GDP growth of around 2.5% in 2019.**

Amidst the re-acceleration of domestic demand in Q2, core inflation has also been staging a moderate pickup from weakness earlier this year—weakness that Fed Chairman Powell described at the time as likely "transitory." Nonetheless core PCE inflation is still running at only 1.6% year-over-year, below the Fed's 2% target, and the recent pickup in real activity has occurred against a backdrop of now-lower market interest rates and generally looser financial conditions, all of which suggests the Fed may have over-tightened a bit last year. Additionally, the trade war and other global challenges have been hitting a number of industries, necessitating many companies to rethink their supply chains and capex plans.

We thus expect the Fed will need to ratify at least a portion of the rate cuts the market has been pricing in for the pickup in domestic demand to be sustained and to get inflation back to 2%. Our base case now incorporates two rate cuts in the second half of 2019—more than the median Fed projection, but less than the three cuts the market has been pricing in.

Euro Area: The euro-area economy seemed weighed down by prolonged and intensifying global uncertainties in Q2. After a modest recovery earlier in the year, the manufacturing sector appeared to have entered recession during the quarter as output declined materially in April, exports continued to slide, order books remained slim, and business sentiment stabilized at low levels.

The domestic economy has so far held up well amidst notable signs that domestic demand is well past its prime. The labor market keeps on humming, but wage growth appears to have peaked. Job creation, although still solid, continues to ease while hiring intentions are sliding. **Amidst overall strong household sentiment, consumption is likely to continue to support the expansion. However, if the trade war were to re-escalate at some point, this could quickly undermine investment and labor demand, thus exposing domestic demand to headwinds.**

As the Fed is considering policy easing, the feedthrough effects of any possible euro appreciation would further complicate the ECB's task of meeting its inflation target. Against this backdrop, the central bank halted its earlier monetary policy normalization and extended its forward guidance. Emphasizing that the ECB has not depleted its ammunition, President Draghi raised several policy options: further modifying forward guidance, cutting interest rates deeper into negative territory, and resuming asset purchases. Although Draghi's remarks were cheered by markets, building consensus in the Governing Council is likely to take time. **In a first step, we expect the ECB to adopt a formal easing bias at its policy meeting in late July followed by likely rate cuts (possibly in conjunction with tiering) in September. However, the bar for resuming asset purchases appears rather high.**

Besides economic challenges, political challenges also abound. The Italian governing coalition is on the brink and its 2020 budget policies risk roiling markets again. In Germany, the poor showing of the governing parties in the European parliamentary elections may presage the end of the Merkel era, especially if the center-left Social Democrats decide to topple the current coalition to rejuvenate the party on the opposition benches.

Japan: Japan's GDP growth has been rebounding from weakness in the second half of last year, with domestic demand re-accelerating to a 1.1% pace year-over-year in Q1. Moderate growth in consumer spending is supported by ongoing strength in hiring and a rising labor force participation rate, while actual and planned business investment continue to grow at a solid pace. Japan's export sectors, however, have been hit by the global economic slowdown, exacerbated by a protracted downturn in the tech cycle.

The consumption tax hike scheduled to take effect in October 2019 is expected to create significant quarterly volatility as consumers front-load purchases in Q3, with subsequent payback likely in Q4. However, its overall dampening effect on GDP growth should be partly mitigated by its smaller size and scope (relative to the 2014 increase) and by increased government spending. With inflation still running less than 1% and Japan's economy exposed to downside risks from the consumption tax hike and weaker global growth, there is speculation that the Bank of Japan may also step in with additional easing, particularly if the yen were to strengthen further. Further QE purchases or adjustments to its yield curve control policy seem to be the most likely means.

China: China's growth continued struggling to gain momentum in Q2—evidenced by disappointing data releases for high-frequency activity indicators, such as industrial production and investment—while forward-looking sentiment indicators also rolled over. The breakdown in the trade negotiations in early May contributed to the souring of expectations, as external trade metrics have continued their downtrend. Through much of this year, economic stimulus has been delivered with less urgency than we had anticipated, and the takeover of troubled Baoshang Bank has rekindled concerns about stress in small and midsize banks. More recently, though, we see indications that heftier stimulus measures are being rolled out, e.g. a broader use of local government special bonds in leveraging infrastructure projects, steps to improve liquidity in the bank and non-bank financial system, and the PBoC Governor's recent reminder that Chinese policy makers still have large policy capacity. **Going forward, we expect policy stimulus to reach a mass sufficient to lift economic momentum in line with the**

authorities' growth target, albeit at the cost of a once more accelerating debt ratio. Aside from related financial-sector risks, a more significant slowdown in the property sector stands as a key downside risk.

Emerging Markets: Economic activity in the major emerging market economies has continued the decelerating trend that took hold late last year. Notably, Q1 saw the largest number of EMs with negative growth (on a quarter-to-quarter basis) since the global financial crisis, and the available data show little evidence of a broad-based rebound in Q2. One common factor behind this soft performance has been the recent stagnation in global trade.

Idiosyncratic country factors also have restrained growth. In South Africa, for example, the newly elected parliament and president have not yet taken decisive policy actions to stimulate growth after years of poor economic management and rampant corruption. The new government has promised such actions, but it will be a long journey. In Brazil, persistent uncertainties have amplified the economy's structural growth shortcomings to render a rather lackluster recovery; indeed, growth is now poised to come in near 1% for the third consecutive year. The Argentine economy remains mired in recession as the implementation of the IMF-backed adjustment program continues to correct macroeconomic imbalances. But an expected recovery through the second half of 2019 should improve the backdrop for the upcoming general elections. Heightened uncertainty in Mexico over the direction of economic policy under the AMLO administration has become a headwind to an already soft growth outlook. This factor partly justified the downward revision of Mexico's credit rating and outlook by Fitch and Moody's, respectively. The risk that trade tensions with the U.S. resurface over immigration adds to the challenges.

Going forward, the efforts by major central banks to provide stimulus and China's expected stimulus should provide some support for economic activity among the EMs. In addition, the authorities in these countries will likely implement growth-supporting measures. In Russia, macroeconomic stability is well entrenched, and the central bank has embarked on an easing path in conjunction with an ambitious infrastructure investment program. Also, the threat of sanctions seems to be receding. In Latin America, the central banks of Brazil and the Andean region may inject additional monetary stimulus. In Asia, further monetary easing is projected across the board with fiscal stimulus also accompanying the effort in India. Further, the generally market-friendly outcome of elections in India, Indonesia, and the Philippines should help reduce the political uncertainties that these countries have faced.

Developed Market Rates

Interest rates across the G4 tumbled throughout the second quarter (Japan -7 bps, Germany -25 bps, UK -17 bps, UST -40 bps) driven by lackluster global economic data, lingering U.S./China trade tensions, and rising probabilities of easier global monetary policies. The Fed's shift towards a more accommodative stance culminated in its June meeting with a drop in the median estimate of the long-run neutral Fed funds rate from 2.8% to 2.5%—the top of its target range as Q3 commenced. While our base case calls for two rate cuts in the second half of 2019 and an additional cut in 2020, that remained less than the market's pricing of 71 bps of cuts through the end of 2019 and 106 bps of cuts through the end of 2020.

While nearly all developed market rate complexes reached multi-year lows in Q2, **we expect U.S. Treasuries to remain bid until the emergence of either the Fed's first rate cut or a resolution to the U.S./China trade conflict. Our preferred bullish rate expression in the U.S. is in 5- 10-year TIPS (real yields of +23 bps and +31 bps at quarter end, respectively)—particularly amid deeply negative 10-year real rates of -2.50% in the UK and -1.30% in Germany—and we remain biased toward a steeper nominal yield curve.** Given the potential sources of uncertainty, we feel that the lows for implied volatility may be in the past, thus we're avoiding volatility-selling strategies. In addition, derivatives remain rich to cash, and we hold basis positions in futures and swap spreads across the U.S. rates complex.

European economic and inflation data remained soft in Q2, which contributed to a bull flattening of the Bunds curve. **Although we believe many DM rate curves have reached their respective lows, we continue to expect rates in the Eurozone to remain low and rangebound given the economic malaise, potentially rising trade tensions later this year, and lingering Brexit uncertainty. Similarly, given the Q2 rally in JGBs, we believe yields have reached their lows and will stay low and rangebound going forward.**

Outlook: Tactical. Although rate complexes across the G4 collapsed in Q2, the move lower was justified by further moderation in global economic conditions. Therefore, we expect low and rangebound rates in Europe and Japan. U.S. Treasuries—particularly real rates—may see additional support until a catalyst potentially contributes to a short-term correction.

Agency MBS

Agency MBS underperformed rates in Q2 with excess returns of -39 bps vs. Treasuries, and option adjusted spreads widened 6 bps vs. Treasuries and 10 bps vs. LIBOR, putting them at multi-year wide levels. Higher supply, lower primary mortgage rates, faster prepayment speeds and worsening characteristics of new production weighed on the sector as did the lack of Fed MBS purchases as prepayments increased and balance sheet reinvestments went back into U.S. Treasuries. With prepayments higher and TBA convexity worsening, investors had to reprice MBS meaningfully wider without the Fed's support. The Fed's SOMA MBS holdings have dropped to $1.53T from a peak of $1.78T in June 2017 and paydowns should exceed the $20B reinvestment cap by only small amounts in Q3. PGIM Fixed Income's OAS model remains positively sloped toward premium coupons within both 30-year UMBS and GNMA2s; intermediate 15-years look tight to 30-years but are technically well supported and prepay speeds remain contained compared to 30 years. **We continue to favor specified pools, despite high price premiums to avoid TBA deliverables. Going into the latter part of Q3, we believe current cheapest-to-deliver pools in UMBS premium coupons may be worthwhile to consider as prepayment burnout may become evident into year end.** Within GNMA2s, post-peak speed pools remain highly sought after as investors look to avoid peak speed GNMA2 pools. Agency CMOs have offered an alternative to MBS as specified pools have richened and secondary CMO inventory appears available. Depending on investor appetite, stripped down coupon Agency CMOs backed by premium GNMA2 coupons appear attractive relative to tight valuations on lower coupon 30-year agency passthroughs.

As expected, Mark Calabria was sworn in as the director of the Federal Housing Finance Agency (FHFA) in April 2019. With UMBS fully implemented, Calabria's recent comments have focused on GSE reform, putting the market on edge. Yet, avenues for genuine housing reform are unlikely without Congressional support. Headline risk will remain high over the coming quarters, but any GSE reform without maintaining an implicit guarantee for legacy securities could negatively impact spreads given the increased size of the Agency guarantee books and importance of other Agency-sponsored sectors, such as CMBS. Given the current state of the Agency MBS sector, positive factors include the wide levels of MBS nominal and option-adjusted spreads, support from yield and convexity buying, as well as potential demand from banks if the Fed delivers on market expectations. Offsetting these positives include higher seasonal supply, UMBS headwinds, Calabria's headline risk, and higher prepay speeds over the next few months. **Given that backdrop, we continue to favor specified pools in lieu of TBAs as a core theme. We prefer 30-year 3.5% within the coupon stack, to avoid heavy 30-year 3% production at current rate levels. Within intermediates, modest weightings of 15-year 2.5% and 15-year 3.5% pools over lower 30-year coupons may be a defensive play against 30-year supply. We continue to favor 30-year GNMA2 higher coupons over lower coupons.**

Outlook: Positive vs. developed market rates. Nominal and option-adjusted MBS spreads remain at multi-year wides and lagged tightening in other high-quality sectors. Given the decline in primary rates, it may take longer than usual for seasonal supply to stabilize. If the Fed cuts rates, we could see banks increase MBS holdings. We continue to prefer specified pools and to avoid TBA exposure. We favor modest up-in-coupon exposure away from 30-year 3%. We expect to add higher 30-year UMBS coupon exposure later in Q3.

Securitized Products

Sector	Subsector	LIBOR OAS	Spread Change (bps)	
		6/30/2019	Q2	YTD
CMBS				
CMBS: Conduit 2.0	First-pay 10-year	86	-1	-17
CMBS 3.0 Conduit BBB-	BBB-	295	-12	-125
CMBS: CMBX (OTR)	AAA	52	-4	-25
CMBS: CMBX (2012)	AA	80	-25	-66
CMBS: Agency Multifamily	Senior	58	-1	-10
Non-Agency RMBS				
Legacy	RPL Senior	79	-15	-28
Legacy	'06/'07 Alt-A	145	5	-5
GSE Risk-Sharing	M2	232	-1	-58
CLOs				
CLO 2.0	AAA	128	-5	-7
CLO 2.0	AA	180	-5	-25
CLO 2.0	BBB	350	-30	-75
ABS				
Consumer ABS	Seniors (One Main)	95	20	10
Consumer ABS	B (One Main)	140	35	25
Refi Private Student Loan	Seniors	95	10	0
UK Non-Conf 2.0 Senior	A Class	100	-5	-35
Generic	AAA Credit Card	35	9	5

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Non-Agency: Housing fundamentals remain benign with the 100 bp rally in mortgage rates alleviating the affordability scare of late 2018. Nevertheless, we expect future home price gains to be in the 2-3% area going forward, which may put some pressure on the more bullish expressions of the RMBS market. Overall, we remain constructive on mortgage credit, with credit availability stable to improving and credit underwriting standards remaining quite high. We expect RMBS spreads to remain rangebound in Q3. We find loss-taking legacy non-agency seniors increasingly uncompelling relative to more scalable and less idiosyncratic alternatives. **Our favorite non-agency RMBS investments are the bespoke senior financings of higher quality mortgage pools that we have been able to execute at spreads of roughly L+150 bps, roughly unchanged in Q2.** UK ABS/RMBS spreads have held in despite a softening in broader markets and uptick in Brexit-related headlines. We are neutral on the sector at these current spreads. The UK appears to be ahead of the U.S. in the transition from LIBOR and new issue SONIA (Sterling Overnight Interbank Average Rate) deals are being originated in the space.

CMBS: Commercial real estate (CRE) fundamentals appear generally stable. Vacancies, aside from retail, are low, and although CRE prices may be 30% higher than the 2007 peak, valuations appear reasonable with cap-rate premia to Treasuries in line with long-term historical averages. Full year conduit supply is expected to be $30-$35B in 2019 compared to $40B in 2018. **In CMBS conduit transactions, we remain biased toward senior tranches from broadly diversified deals over mezzanine tranches, although that preference was somewhat frustrated in Q2 amid the rally in mezzanine spreads.** In single-asset/single-borrower transactions, our investments range from seniors to mezzanines depending on the specific property fundamentals. In the Agency CMBS market, GSE reform is creating some uncertainty, particularly around future issuance. Although technicals could turn very positive if supply were to wane, episodic rhetoric from the FHFA has created some uncertainty around the status of the implicit guarantee. **We continue to like Agency CMBS as a diversifier.**

ABS: ABS collateral performance remains stable across asset types—consistent with strong employment conditions and responsible consumer credit underwriting standards. We expect the benign collateral performance to persist, but we are wary of underwriting excesses at the margins, including certain marketplace lenders and deep subprime auto originators. Going forward, moderate new issue supply (2019 YTD new issuance is $105B, slightly below 2018's pace) and manageable secondary dealer balance sheets provide a positive technical. For lower beta asset types (credit cards/autos), the rate rally contributed to wider spreads as investors sought more spread to maintain all-in yields. We continue to have an up-in-quality focus—capital stack/issuer compression remains prevalent and senior tranches are clearing at, or wider than, average 2018 spreads. **We favor issuers with strong legal and compliance procedures in unsecured consumer loans, subprime autos, and private refinance student loans, with a strong bias toward those with income-based underwriting models over those that rely on FICO scores.**

CLOs: CLO technicals are challenging as new issue supply remains ahead of expectations and investor appetite for floating-rate assets remains soft given the Fed's dovish tone. Fundamentally, senior CLO tranches remain resilient to underlying bank loan credit performance due to significant credit enhancement and underlying portfolio diversification. Defaults in bank loans remain low as financing markets remain extremely receptive to supply and underlying economic fundamentals remain well supported. **However, we expect that recoveries in the next default cycle will be lower relative to historical observations. We believe that the increase in loan-only capital structures will dampen recoveries and that some loans will be indistinguishable from traditional high yield bonds upon default.** In the primary market, top-of-the-capital structure CLO spreads have lagged this year's broader spread rally. Despite the lack of spread compression in five-year reinvestment period deals, we have seen a CLO-term structure reemerge as shorter spread duration deals have become very well bid. **We expect top tier AAA spreads to remain within a 5-bps range of recent levels and AA spreads to remain around 50 bps wide of AAA spreads.** At these spreads, senior CLOs continue to offer excellent risk-adjust returns, but we remain cautious on mezzanine tranches as spreads do not reflect the potential for lower loan recoveries, higher cashflow variability, higher ratings volatility, ephemeral liquidity, nor the higher mark-to-market volatility of these tranches.

Outlook: Positive. We remain biased toward top of the capital structure, which offers high risk-adjusted spreads for fundamentally remote credit risk. We generally remain negative on mezzanine structured products and remain mindful that Q3 has historically had meaningful bouts of volatility. Thus, Q2's intra-quarter volatility reaffirms our quality bias amid the ageing credit cycle, slightly deteriorating collateral quality, and flat securitized credit curve.

U.S. and European Corporate Bonds

U.S. and European corporate bonds again delivered positive returns in Q2, rallying on weaker global economic growth and dovish comments from the Fed and ECB. Although volatile at times, both markets strengthened in June and remain supported against a backdrop of slow but constructive economic growth, low inflation, strong technicals, and central banks that appear poised to ease rates and/or employ other stimulus measures.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q2	YTD	Q2	YTD	6/30/2019
U.S. Corps.	4.48	9.85	-4	-38	115
European Corps	2.16	5.42	-11	-40	112

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U.S. Corporate Bonds: U.S. corporate profit margins and free cashflow remain strong, although Q2 earnings are expected to weaken from elevated levels. Overall credit metrics remain stable, and M&A deals have slowed. While a meaningful universe of highly-leveraged BBB-rated issuers remains, a number of these companies are taking steps to reduce debt. In an interesting move, both AT&T and CVS have even tied lower leverage targets to management's compensation.

On the supply side, new issuance was brisk with a range of concessions and deals three times oversubscribed, on average. With nearly $12T of negative yielding global debt outstanding (see Figure 4 in the Bond Market Outlook), corporate bonds benefitted from investors' reach for yield, especially from non-U.S. investors. Light dealer inventories also provided support. For the year, gross and net U.S. corporate issuance is projected to decline about 10% and 30%, respectively.

As in prior quarters, we continue to overweight lower-quality, shorter maturities and underweight higher-quality, long-maturity corporates. All of the 18 largest U.S. banks passed the Federal Reserve's most recent stress test, underscoring our conviction that the major banks are well capitalized and should be able to withstand any future adverse conditions. **We also favor select European banks for their attractive spread levels, electric utilities, and taxable municipal bonds over industrials that may be subject to event risk or slowing economic growth. We are negative on lower-rated financials. We are searching for value in BBB-rated issuers that are poised to deleverage (select healthcare, telecom, and pipelines) and are finding value in select post-event issues.**

European Corporate Bonds: European corporate spreads also tightened in Q2 and now sit nearly 40 bps lower than at the start of the year. In many respects, the European corporate backdrop is similar to the U.S.—positive growth, low inflation, credit fundamentals that remain strong but are likely past their peak, investors seeking yield, and accommodative central banks. The ECB plans to launch a new TLTRO program designed to preserve favourable bank lending and extended its "no rate hike" pledge to June 2020. Depending on upcoming data, some market participants are even looking for a rate cut this fall or a restart of the corporate bond purchase program.

Unlike the U.S., politics (Brexit, Italian budget, trade wars, etc.) add another source of volatility and could hold back further spread compression. In addition, European corporate issuance has risen sharply, up about 20% vs. the same period last year. A good portion of this supply is from U.S. companies issuing in euros to lock in lower absolute rates. Investment banks are also running low inventories, which can exaggerate spread movements at times.

In European portfolios, we are slightly short spread duration. We remain overweight banks, but are looking to reduce exposure into market strength. We are also overweight insurance and non-core REITS, as well as non-euro issuers. We remain overweight U.S. corporate issues denominated in euros and are taking advantage of companies coming to market with large concessions.

Global Corporate Bonds: The value of USD and EUR spreads appears roughly even following the recent spread tightening. We remain flat to underweight GBP credit spreads and, as in EUR portfolios, are slightly short spread duration. We still prefer money center banks and U.S. utilities denominated in USD, as well as banks and select corporates denominated in EUR (but not necessarily European companies). We continue to take advantage of price and yield dislocations between EUR and USD bonds of the same and/or similar issuers.

Going forward, we hold a positive short-term view on both U.S. and Europe corporates, but volatility could emerge as new data are released. Spreads have already tightened solidly, yet

may likely push tighter amid low, but stable, growth and strong supply/demand technicals. Risks include geopolitical tensions, trade disruptions, softer economic growth across major countries (including China), and a flattening/inverted U.S. yield curve.

Outlook: Positive near term given favorable fundamentals, healthy technicals, and potential for tighter spreads. We still favor U.S. money center banks. U.S. tax reform remains supportive.

Global Leveraged Finance

	Total Return (%)		Spread Change (bps)		OAS/DM (bps)
	Q2	YTD	Q2	YTD	6/30/2019
U.S. High Yield	2.57	10.16	+2	-126	407
Euro High Yield	2.38	7.68	-28	-138	381
U.S. Leveraged Loans	1.58	5.42	-7	-90	460
Euro Leveraged Loans	1.15	2.70	-11	-234	424

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U.S. Leveraged Finance: In a volatile Q2, U.S. high yield spreads approached year-to-date tights in April, widened by almost 100 bps in May, and subsequently recovered in June. Energy was the only sector in negative territory following a 24% peak-to-trough decline in crude oil prices, and the retail sectors generally outperformed.

After a slow start to Q2, the new issue pipeline eventually ramped up and ended the quarter on the back of the most active month since January 2018. Year-to-date, the market has priced $140.5B in gross proceeds, compared to $112.0B that priced over the same period last year. This year's net volume stands at $46.6B, which represents about an 4% increase year-over-year. **Despite the modest pick-up year-over-year, new issue volume has been trending lower over the past several years**. **The quality of the new issue calendar continues to improve with almost 89% of 2019 volume coming from the higher-quality tiers (i.e., above split-B rated).** This compares to 87.6% over the same period last year and an annual average of 83.6% going back to 2010.

Looking ahead, Moody's expects the global default rate to reach 2.4% by the end of Q2 2020. With current spreads adequately compensating for recession risk, strong credit fundamentals, and low default expectations, we remain constructive on U.S. high yield. The relatively better insulation of U.S. high yield credits from the protracted trade war with China, combined with the technical support provided by stimulative central bank policies—in an already supply-limited asset class—supports our favorable view.

In terms of positioning, we prefer single-B rated credits and are taking advantage of the steepness of the spread curve via an underweight to low-spread, short-dated issues, in conjunction with an overweight to the 4- to 7-year portion of the curve. We continue to balance our modest overweight to CCCs with positioning in AAA-rated CLOs. We are maintaining overweights to independent power producers and U.S. consumer-related names, while remaining cautious on commodities. We're also selectively allocating to the auto sector. Looking ahead, risks to the market include negative global growth implications associated with ongoing trade disputes and rising populism, and margin compression, partly resulting from tight labor markets and rising costs for issuers.

Despite continued retail outflows, support from strong CLO creation, interest from separate accounts, and loan paydowns supported the U.S. leveraged loan market. Outflows from loan funds persisted in Q2, as the market reported 31 weeks of outflows over a 32-week span. In aggregate, $18B has left the asset class in 2019. **Looking ahead, we believe retail flows will remain negative as the market anticipates future rate cuts, but we expect outflows to lessen as a whole. The combination of continued negative outflows and slowing CLO creation will likely lead to a moderation of loan demand overall.**

We continue to favor BB-rated, public company bank loans—preferably with high yield bond cushions—due to the risks around slowing global growth, ongoing trade tensions, and weak loan documentation. However, we acknowledge the risk of lower near-term carry with this view. We believe the risk to the retail, technology, auto suppliers, energy, and pharmaceutical sectors are the most prevalent, while the outlook for the building products, gaming, and cable sectors are stable or improving. **We believe security selection will become increasingly important if global growth continues to slow and creditor protections weaken.**

European Leveraged Finance: European high yield continued its strong start to 2019 with higher-rated credits faring the best in Q2. However, lower-quality credits have still outperformed YTD. Gross high yield issuance totaled €20B in Q2, which is more than double the €9.4B that priced in Q1. Despite the jump in supply during the quarter, 2019 gross issuance is down more than 40%. After dropping below 1% for the first time since September 2008 in Q1, Moody's European default rate is now at 0.9%, and we do not expect this to meaningfully change in the foreseeable future. European leveraged loans posted +123 bps of excess returns vs. swaps in Q2, taking year-to-date excess returns vs. swaps to +287 bps. Loans continue to be less volatile than bonds, but meaningfully lag the strong performance of European high yield this year. Loan issuance remained broadly flat to Q1 and still meaningfully lags year-on-year (€38bn in 1H19 vs. €62bn in 1H18), continuing to leave the market technically well supported.

We remain constructive on European high yield given benign default expectations, favourable supply technicals, dovish

central banks, and our expectation of a resolution of the U.S.-China trade dispute in the near to medium term. In terms of positioning, we continue to believe selected B-rated issuers offer better risk/reward vs. BBs, and, if the market remains constructive, compression of the lower-rated (but performing) credits will likely be a theme during the second half of 2019. Within loans, our constructive view remains amid supportive technicals. However, caution should be exercised given weak underwriting standards. On a relative value basis, we continue to prefer European high yield vs. loans, but the differential is less pronounced than at the start of the year and requires assessment on a case-by-case basis.

Outlook: Constructive on U.S. high yield, particularly in the belly of the curve, with a preference for Single Bs. We favor the higher-rated portion of the U.S. leveraged loan market. In Europe, we prefer high yield to bank loans.

Emerging Markets

Each emerging market debt sub-sector posted positive returns in Q2 (while not shown below, unhedged local bonds outperformed with a Q2 total return of +5.64%). The sector continued to benefit from investors' search for yield amid expectations for Fed rate cuts and ongoing, below-trend growth in most developed markets. The prospects for a global recession in the near to medium term also remain faint given the relatively healthy growth in the U.S. and expectations for additional stimulus from China. The prospect for avoiding a full-blown U.S./China trade war is key for EM as further slowing in global trade and EM growth would pose a headwind regardless of policy accommodation from DM central banks.

	Total Return (%)		Spread / Yield Change (bps)		OAS (bps)/ Yield %
	Q2	YTD	Q2	YTD	6/30/19
EM Hard Currency	4.08	11.31	-5 bps	-69 bps	346
EM Local (hedged)	3.22	5.26	-0.48	-0.77	5.69
EMFX	2.07	3.57	-0.96	-0.22	5.08
EM Corps.	3.50	8.83	-3 bps	-38 bps	333

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EM Hard Currency Sovereigns: In EM sovereigns, the performance by country reflected the UST rally and idiosyncratic developments. Some higher rated, more UST sensitive names outperformed, including Qatar, Russia and Romania, all returning over 6% and tightening between 20-30 bps. The other outperformers were those with positive developments, including Ukraine (+10.2%), Mozambique (+17.1%), and Tunisia (+8.6%). The underperformers reflected political risk and uncertainty, including Venezuela (-33.2%) and Zambia (-5%). Looking forward, there may be opportunities for the underperformers to post attractive returns later in the year. In the case of Argentina, a victory by incumbent President Macri would lead to a marked repricing as its bonds are trading with a default probability of over 50%. Turkey, downgraded to B1 by Moody's on June 14, remains mired in economic and policy uncertainty, but the recent victory of an opposition candidate in Istanbul prompted a rally and more upside is likely. While South Africa was able to stave off a Moody's downgrade to high yield in Q2, remaining challenges to President Ramaphosa's generally orthodox stance amid a weak economy could pressure its last IG rating.

Local Rates: While the global backdrop for EM local rates remains constructive on the back of slowing inflation, below-trend global growth, and generally positive real rates, the recent rally in EM rates seems over extended as interest-rate cuts in many countries are now priced in, and the 5.69% yield on the GBI-EM benchmark is at a five-year low. Furthermore, almost every country experienced curve flattening as the global data surprised on the downside, central banks turned dovish, and yield-hungry investors added duration. That said, there are countries where rate cuts are not priced in, but may still materialize.

FX: The case for EMFX remains uncertain even after the U.S. dollar returned -1.19% vs. G10 and -2.07% vs. EM in Q2. Going into Q3, the trade uncertainty is not particularly supportive of FX. On the other hand, the Fed appears likely to cut rates, and if it reverses the slide in inflation breakevens, this will be a net positive for FX as will potential infrastructure and property stimulus out of China.

In terms of positioning, we continue to favor spreads, particularly select, lower-rated sovereign issuers with proven market access and/or IMF support, including Ecuador, Ukraine, and issuers in sub-Saharan Africa. We remain overweight to Argentina on the expectation that a favorable election outcome will significantly reduce default probabilities. We also find select quasi-sovereigns attractive. We continue to see value in Pemex at current levels of +300 bps (and potentially more) wide to the sovereign as Mexico views Pemex as inextricably linked and will follow with measures to support it more explicitly. The continued inclusion of the Gulf Cooperation Council countries in the index provides opportunities in those IG names. Other higher-quality exposures include Indonesia considering its domestically-oriented economy and Russia given its very strong credit fundamentals. In EM corporates, we like the Brazilian protein sector amid swine flu epidemics elsewhere, select higher-rated China property issuers with access to onshore debt market liquidity, and Indian quasi-sovereigns given the government's strong mandate. EM corporate fundamentals remain solid and while new issue supply has picked up recently, it is still running below last year's levels.

In EM rates, our active overweight duration positioning is in countries where we expect easing central bank policies (China, Mexico, Indonesia, and Russia) in the second half of 2019. Regionally, our largest exposure is in Asia (China, Indonesia, Thailand, and Philippines), and our second largest exposure

is in Mexico. Except for Mexico, we are close to neutral duration in Latin America. In CEEMEA, our active overweight is in Russia and Poland with underweights in Hungary and Romania.

Our active FX positioning is net short the U.S. dollar with a focus on relative value in EMFX. We reduced our net long in the dollar from a high point in May. Our major longs are in Russia, Mexico, India, and Egypt—currencies with high real yields, manageable external accounts, and attractive valuations in the case of Mexico and Egypt. Major shorts include Chile, Brazil, Hungary, and China—currencies exposed to global trade slowdown (Chile and China), easing central banks (Chile, Brazil, and China), weak growth (Brazil), and/or unattractive real yields where the central bank is politically influenced (Hungary).

Outlook: Conditionally constructive for spreads, select local bonds, and EMFX—assuming a reasonable outcome to trade negotiations and clearer evidence of growth in China. With the caveat that a supportive backdrop could fail to materialize, there is scope for attractive spread tightening in investment grade and high yield countries and corporates. The outlook for EMFX and rates is less clear, but attractive relative value opportunities remain.

Municipal Bonds

In Q2 2019, AAA municipal yields were lower by 23 to 32 bps across the curve. While municipals outperformed U.S. Treasuries slightly on the long end, they could not keep pace with the rally in Treasuries and underperformed 10-years and in on the curve. The 10-year and 30-year Muni/Treasury yield ratios finished the quarter at 81.5% and 91.5%, respectively, over four ratios higher in 10 years and close to unchanged in 30 years. An environment of declining rates and attractive taxable equivalent yields continued to support strong demand for tax-exempt municipals. Mutual fund net inflows exceed $43B YTD, the strongest start to a year on record.

The municipal yield curve flattened by 3 bps with the 5/30s at 100 bps. Total returns for Q2 were +2.14% for the high grade and +2.73% for the high yield indices with YTD total returns at +5.09% and +6.66%, respectively. Long-taxable municipal finished Q2 with total returns of 5.85%, underperforming the long corporate index (+7.23%). Excess returns for long taxable municipals of +121 bps lagged the long corporate index (+228 bps).

Supply was readily absorbed with gross supply of $88.7B in Q2, an 11.4% decline from the prior year, and $167B YTD, slightly higher YOY. The Q2 supply excludes the $12B restructured COFINA bonds, which began trading in Q1 following the debt exchange. The restructured COFINA bonds are non-rated and represent approximately 7.5% of the Bloomberg Barclays High Yield Muni Index.

As expected, many states experienced sharp rebounds in tax revenues in March and April as taxpayers delayed their tax filings. As a result, YOY tax revenues for the fiscal YTD through April were up significantly. Given the length of the current economic expansion, many states are prudently allocating monies to budget stabilization and rainy-day funds.

The positive technical framework is expected to remain in place through the summer months as net supply is forecasted to be negative. In addition, a stable to declining rate environment will likely contribute to continued mutual fund inflows. While increased net supply closer to the end of Q3 may pressure tax-exempts, any spread widening and underperformance will likely represent a buying opportunity. While the successful COFINA debt exchange and relatively stable trading activity exceeded market expectations, focus will remain on the Federal Oversight and Management Board's (FOMB) proposed GO debt restructuring agreement released in Q2. The disconnect between GO trading levels and the FOMB's proposed recovery values indicates the expectation that negotiations with creditors will continue.

Finally, we continue to expect taxable municipals to perform in line with corporate bonds, with potential for outperformance in a corporate spread widening environment.

Outlook: Moderately positive. Strong technical framework and fair valuations should lead to outperformance vs Treasuries.

Important Information

Source of data (unless otherwise noted): PGIM Fixed Income and Bloomberg as of July 2019

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U.S. Investment Grade Corporate Bonds: Bloomberg Barclays U.S. Corporate Bond Index: The Bloomberg Barclays U.S. Investment Grade Corporate Bond Index covers U.S.D-denominated, investment-grade, fixed-rate or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements. Securities included in the index must have at least 1 year until final maturity and be rated investment-grade (Baa3/ BBB-/BBB-) or better using the middle rating of Moody's, S&P, and Fitch.

European Investment Grade Corporate Bonds: Bloomberg Barclays European Corporate Bond Index (unhedged): The Bloomberg Barclays Euro-Aggregate: Corporates bond Index is a rules-based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.
U.S. High Yield Bonds: ICE BofAML U.S. High Yield Index: The ICE BofAML U.S. High Yield Index covers US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, and at least one year remaining term to final maturity as of the rebalancing date.

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

Important Information

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

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

Emerging Markets U.S.D Sovereign Debt: JP Morgan Emerging Markets Bond Index Global Diversified: The Emerging Markets Bond Index Global Diversified (EMBI Global) tracks total returns for U.S.D-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. To be deemed an emerging market by the EMBI Global Diversified Index, a country must be rated Baa1/BBB+ or below by Moody's/S&P rating agencies.

Emerging Markets Local Debt (unhedged): JPMorgan Government Bond Index-Emerging Markets Global Diversified Index: The Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM Global) tracks total returns for local currency bonds issued by emerging market governments.

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

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

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

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

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

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

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

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