PGIM FIXED INCOME

Q1 25

QUARTERLY OUTLOOK

Published January 2025

WHATS INSIDE?

Select a section to jump ahead.

	Total Returns (%)				
Individual FI Sectors	**Q4 '24**	**2024**	**2023**	**2022**	**2021**
U.S. Leveraged Loans	2.29	9.05	13.04	-1.06	5.40
European Leveraged Loans	2.01	9.17	13.53	-3.36	4.87
European High Yield Bonds	2.00	9.14	12.78	-11.13	3.32
European IG Corporate	0.87	4.74	8.19	-13.65	-0.97
U.S. High Yield Bonds	0.17	8.19	13.45	-11.19	5.36
EM Local (Hedged)	-0.74	3.77	7.60	-8.85	-5.52
Municipal Bonds	-1.22	1.05	6.40	-8.53	1.52
CMBS	-1.48	4.68	5.42	-10.91	-0.64
EM Hard Currency Sovs.	-1.94	6.53	11.09	-17.78	-1.80
U.S. IG Corporate Bonds	-3.04	2.13	8.52	-15.76	-1.04
U.S. Treasuries	-3.14	0.58	4.05	-12.46	-2.32
Mortgage-Backed (Agency)	-3.16	1.20	5.05	-11.81	-1.04
EM Currencies	-4.69	-1.08	8.44	-7.14	-3.09
U.S. Long IG Corporates	-6.20	-1.95	10.93	-25.62	-4.65
Long U.S. Treasuries	-8.62	-6.41	3.06	-29.26	-1.13
Multi-Sector					
Euro Aggregate (Unhedged)	0.14	2.63	7.19	-17.18	-4.71
Global Agg. Hedged	-0.95	3.40	7.15	-11.22	-0.15
Yen Aggregate	-1.38	-3.07	0.51	-5.30	-2.85
U.S. Aggregate	-3.06	1.25	5.53	-13.01	-1.39
Global Agg. (Unhedged)	-5.10	-1.69	5.72	-16.25	-1.54
Other Sectors					
U.S. Dollar (DXY Index)	7.60	7.10	-2.11	8.21	6.37
S&P 500 Index	2.40	25.00	26.29	-18.11	28.71
SOFR	1.20	5.40	5.18	1.66	0.03

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures and full index names. All investments involve risk, including possible loss of capital. Sources: Bloomberg except EMD (J.P. Morgan), HY (ICE BofA), Bank Loans (Credit Suisse). European returns are unhedged in euros unless indicated. Performance is for representative indices as of December 31, 2025. An investment cannot be made directly in an index.

SECTION 1

KEY CONVICTIONS & INVESTMENT THEMES

01

KEY CONVICTIONS & INVESTMENT THEMES

1 **Dips and Carry—Tips for Riding the Bull:** The 2022 bear market hoisted yields to levels not seen in more than a decade, fueling solid fixed income returns since then. Although broad uncertainties will affect short-term conditions, the ongoing bull market demonstrates that elevated yields will likely continue generating attractive returns over the long run. And as 2025 commences, the backdrop warrants "buy-the-dip (in prices)" and carry-oriented approaches.

2 **Dislocations Ahead:** While we expect additional central bank rate cuts to support moderate global economic growth, this outcome is not immune to additional bouts of market upheaval, possibly aggravated by heightened global competition. Given the historically tight levels on credit spreads, periods of market turbulence may also prompt dislocations across certain markets and sectors.

3 **Divergence and Dispersion Opportunities:** As economies/policies diverge and dislocations lead to sector dispersion, opportunities to add value through active management will surface. Whether it is the potential to buy-the-dip or enhance carry, early identification of the affected countries, industries, and issuers—perhaps within the context of further paradigm shifts—assumes newfound importance going forward.

PGIM FIXED INCOME

SECTION 2

BOND MARKET OUTLOOK

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

02

HOLD ON; RIDE THE BULL

No doubt, the fourth quarter of 2024 was a mediocre one for bonds, aside from China (Figure 1). While some headlines relay despair—"After Another Bad Year for Bonds, Investors Lose Faith in a Turnaround[1]"—we would argue that a very different story line is playing out: since the peak in global rates in late 2022, bonds have generally posted strong cumulative returns, which should continue in 2025.

This is not to downplay the potentially expanding divergences across countries and asset classes—these are addressed in the following sections covering economics and the global fixed income sectors. Clearly some countries, sectors, and issuers are lagging, while others move to the front of the pack or extend their leads. This dispersion should continue to afford opportunities for adding value through active management.

But overall, the fixed income story since late 2022 is one of bonds posting respectable returns owing to factors that largely remain in place:

- Moderating economic fundamentals that likely allow most central banks to lower rates further;
- and as investors endeavor to stay ahead of central bank rate cuts, their demand for yield and to lock in an income stream for the long run will likely prevent yields from moving into a new, higher range (Figure 2).

Still Early Stages for the Shift into Bonds

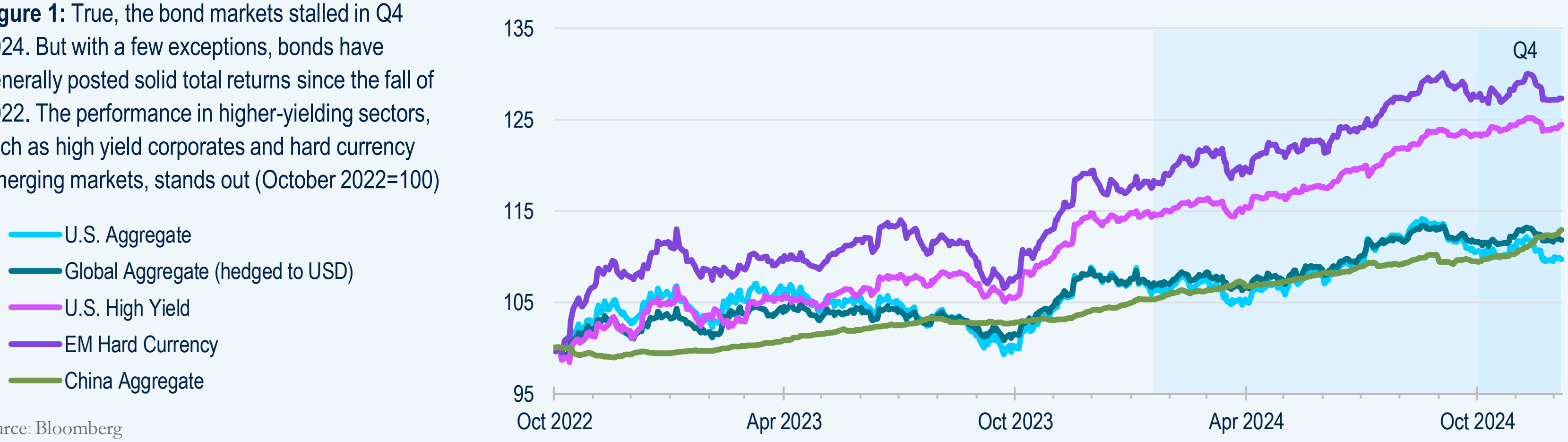
Although investor positioning is difficult to divine, there are at least some signs that cash balances remain elevated and/or rising. As one key indication, money fund balances are extremely high relative to the level of GDP and in absolute terms (Figure 3). This cash may represent latent demand that could shift to bonds if and as central banks continue cutting rates.

An Extended Window for Narrow Spreads

While today's historically tight credit spreads and the experience over the past 20 years point to caution when it comes to credit exposure, this may not be the right approach in the current environment. Instead, given the prospects for continued moderate economic growth, generally benign credit fundamentals, and strong demand for fixed income, we think an extended period of narrow spreads is a more likely outcome. This could manifest as a slightly more volatile version of the 1992-1997 or 2004-2007 periods, in which case credit products may continue delivering positive excess returns (Figure 4).

1 Goldfarb, Sam, "After Another Bad Year for Bonds, Investors Lose Faith in a Turnaround," The Wall Street Journal, December 29, 2024.

Figure 1: True, the bond markets stalled in Q4 2024. But with a few exceptions, bonds have generally posted solid total returns since the fall of 2022. The performance in higher-yielding sectors, such as high yield corporates and hard currency emerging markets, stands out (October 2022=100)



Source: Bloomberg

What about the Risks?

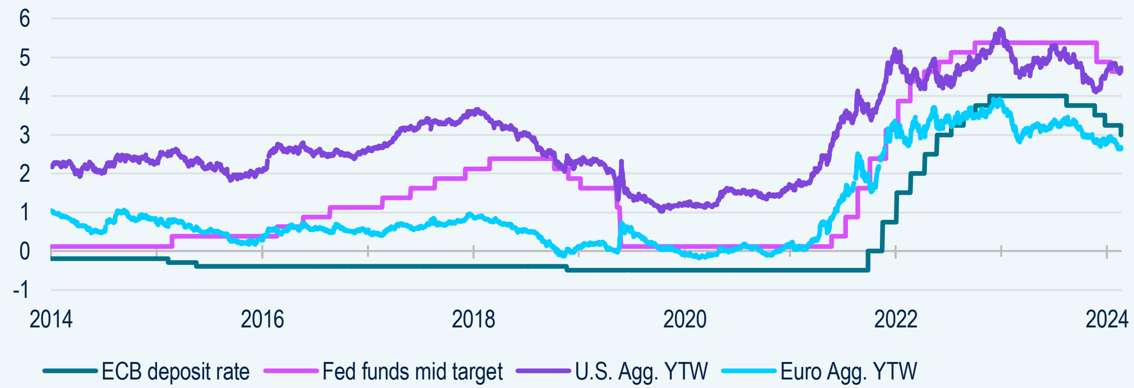
True, geopolitical risks and policy dynamics—in particular trade frictions—could lead to periodic volatility as 2025 progresses. However, since late 2022, the bull market has weathered a series of economic, policy, and geopolitical threats. Looking ahead, we will keep an open mind and will expect more of the same: quarter-to-quarter volatility within the context of a bull market (literally) carrying on (see [the following sector outlooks] for more on carry opportunities).

Conclusion: The Q4 correction provides a solid setup for the bull market to resume.

The Q4 performance lull in the bond market has, in our estimation, set the stage for a solid 2025. No doubt risks abound. But overall, the distribution of outcomes looks skewed towards stable to lower long-term yields and range bound spreads, boding well for fixed income returns. Meanwhile, diverging fundamentals across countries, sectors, and issuers should continue to create opportunities to add value through active management.

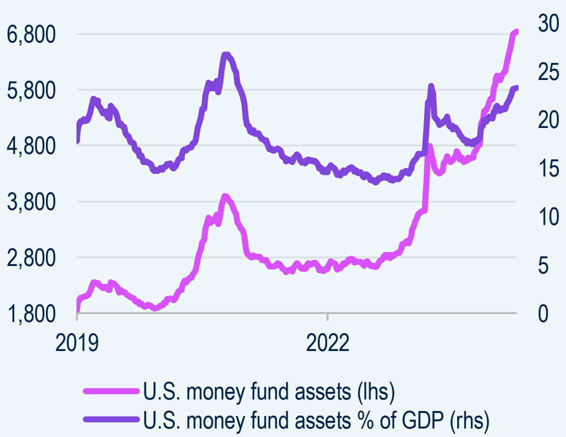
Bottom line: The Q4 correction has set the stage for bull market to resume in 2025, subject to short-term volatility owing to variability in the geopolitical, economic, and policy environment.

Figure 2: Bond yields are likely to mirror the trend in Western central bank administered rates: stable or, more likely, falling as investors keep buying bonds, keen to stay ahead of central banks and lock in a long-term income stream. (%)



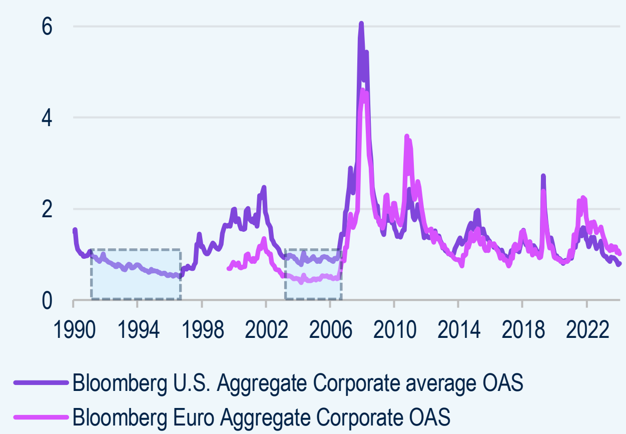
Source: Bloomberg

Figure 3: U.S. money fund balances rose by more than $300 billion in Q4 2024—historic highs on an absolute basis and relative to GDP, suggesting investors remain defensive. This significant pool of assets could shift to bonds if and as central banks continue cutting rates. (lhs: $ billions; rhs: % of GDP)



Source: Bloomberg

Figure 4: While the experience of the past 20 years would suggest caution at todays narrow spread levels, the current backdrop is more akin to 1992-1997 or 2004-2007– i.e., extended periods of narrow spreads. This should allow credit products to continue delivering positive excess returns. (percentage points)



Source: Bloomberg

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Check out more of PGIM Fixed Income's latest thought leadership and media spotlights at PGIMFixedIncome

PODCAST

DEVELOPMENTS ACROSS THE ELECTRIC GRID

This episode explores the complexities surrounding the demand for power generation driven in part by AI advancements and data centers.

WHITE PAPER

REVIVING EUROPEAN SECURITISATION

This paper reflects the views within our recent submission to the European Commission's targeted consultation on the functioning of the EU securitisation framework.

BLOG POST

A BAROMETER TO GAUGE CREDIT MARKET VALUATIONS

We can better assess credit spreads through simple market barometers comparing credit spreads with a variety of macro, fundamental, and technical drivers.

SECTION 3

GLOBAL MACROECONOMIC OUTLOOK

By the Global Macroeconomic Research Team

03

TO EACH ITS OWN

The cliché "American Exceptionalism" can apply broadly. At its most ironic, the term starkly contrasts the near, late-year shutdown of the Federal government and the prospects for further political dysfunction. A more literal interpretation aptly describes U.S. economic growth—and the performance of U.S. risk assets—as they easily outpaced those of other developed market countries last year.

As we look ahead, certain U.S. policies—i.e., expanded tariff use, potential reductions in corporate tax rates, and renewed focus on deregulation—are intended to maintain U.S. competitiveness relative to its global peers. While the effectiveness of these proposals remains to be seen, many economies are seeking their own measures—as opposed to regional partnerships or trade pacts—to accelerate growth (more follows on the EU-Mercosur trade agreement). These heightened competitive actions will likely propagate macro-related developments that are already underway, such as further political polarization, additional supply chain reconfigurations, and more distinct technological ecosystems.

The more immediate, visible effects pertain to global inflation and continued deterioration in fiscal conditions. Symptoms of these effects were on display last year as France's fiscal issues sparked two bouts of market upheaval and credit rating downgrades. On the inflation side, many initially anticipated that developed market central banks would consistently ease policy from generational peaks to neutral rate levels (or thereabouts). However, these easing cycles now appear notably shallower than earlier expectations.

Hence, our outlook over the coming year is shaped by the heightened growth competition among individual economies and their increasingly disparate paths—complete with the undercurrent of relentless geopolitical strife.

Returning to the U.S., its fiscal situation also bears watching amidst the ongoing increase in entitlement spending coupled with the likely extension of existing tax cuts (TCJA), potential for further reductions in corporate tax rates, and renewed prospects that the debt ceiling may again come into play. Despite implementation uncertainties, we can make some general assumptions about potential upcoming policies. In terms of tariffs, a 1 percentage point increase in the effective tariff rate likely translates to a 0.1 percentage point increase in core PCE, a 0.13 percentage point decline in GDP, and $31 billion in additional customs revenue per year (Figure 1). Furthermore, the estimated impact of increased tariffs on the U.S. fiscal deficit through 2029 ranges from nearly $200 billion to $2.1 trillion.[1]

[1] See "Analysis of 4 Political Policy Areas on the U.S. Economy," for methodologies, assumptions, and sources. PGIM Fixed Income as of October 16, 2024.

Figure 1
Estimated growth impact under President Trump's tariff proposals.

Tariff policy	Impact on total effective tariff rate (%)	Core PCE impact (%)	Growth impact (%)	Fiscal revenue impact ($ billion, annual)
60% effective tariff on China	7.98	0.80	-1.04	247.8
10% universal tariff—non-FTA	4.56	0.46	-0.59	141.4
10% universal tariff—FTA	3.04	0.30	-0.40	94.2
Ad-hoc tariffs	2.00	0.20	-0.26	62.0
All tariffs	**17.98**	**1.76**	**-2.29**	**545.0**

Source: PGIM Fixed Income, Bureau of Economic Analysis.

The potential effects of the U.S. competitive measures present some caveats. The first is that the use of tariff proceeds matters greatly, and Congress has the ultimate say on how they are used. The second relates to the sequencing of these policies in terms of how they might affect growth. Risk markets have generally overlooked the potential negative effects of the more immediate policies, such as tariff implementation and immigration restrictions. Instead, they have seized upon the more positive potential effects pertaining to deregulation and adjustments to tax policy, which may take far longer to materialize given the legislative process. Thus, the Trump administration's policy agenda could yield vastly different economic results from one year, say in 2025, to the next.

Such is the situation facing the Federal Reserve. Its easing trajectory now appears far shallower than when it started cutting rates with a 50 bp reduction last September and a 2.9% terminal rate for the cycle (see Figure 2 for the change in policy rate projections in 2024).

The Fed's most recent summary of economic projections did much of the heavy lifting regarding the revised policy expectations. The SEP indicated improving labor stability (with this year's unemployment rate projection falling slightly from 4.4% in September to 4.3% in December), lingering inflation pressures (with its 2025 core PCE inflation projection rising from 2.2% to 2.5%), and the consequent halving of this year's rate cut expectations to only 50 bps. As a result, the Fed's most recent terminal rate and neutral rate projections rose to 3.1% and 3.0%, respectively, and additional increases may follow.

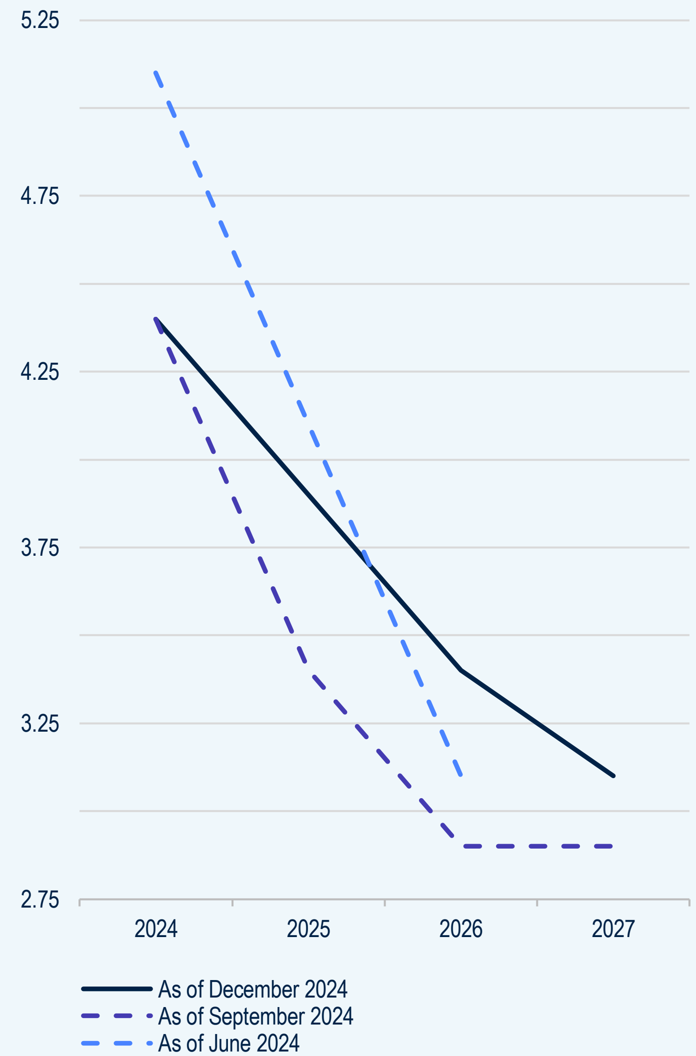
For our part, we expect headline PCE of 2.0% by the end of 2025 (below consensus of 2.2%) and core PCE of 2.2% (in line with estimates). Given the Fed's recalibration, we believe it will hold policy steady at January's FOMC meeting as it awaits more data before resuming, or potentially ending, the current easing cycle. As conditions unfold this year, we think three 25 bps cuts is a reasonable expectation.

A second Trump term and the tariff expansions also coincided with greater urgency from the EU to identify and implement its own growth measures. No fewer than three high-profile reports were released last year with suggestions pertaining to capital availability, energy independence, digital innovation, and trade.[2] Some initiatives, such as efforts to revive the European securitization market, are already underway.

Considering the trade sensitivities and global manufacturing competition, Germany remains a particular weak spot for the EU (Figure 3). Despite the prospect for a change in political

[2] Draghi, Mario "The Future of European Competitiveness– A Competitiveness Strategy for Europe," September 9, 2024; Letta, Enrico "Much More than a Market– Empowering the Single Market to Deliver a Sustainable Future and Prosperity for all EU Citizens," April 2024; and Noyer, Christian (Committee Chairman), "Developing European Capital Markets to Finance the Future," April 25, 2024.

Figure 2
The Fed's policy rate projections shifted significantly in 2024, culminating with the changes from the December FOMC meeting. (FOMC median Fed funds projections, %)



Source: Haver Analytics

leadership, Germany continues to take a conservative approach when it comes to fiscal, which may still act as a drag on the economy until at least the second half of 2025. Weak activity in a large, languishing economy risks spilling over into layoffs and returning Germany to the "sick man of Europe" that weighs on the rest of the EU, especially Italy and Central & Eastern Europe.

Some factors are mitigating Europe's structural constraints. Germany's housing market is showing signs of improvement and rising real wages continue to support German consumers. Furthermore, the EU periphery will continue to benefit from NextGen EU funds this year and in 2026. The combination of the funding, post-sovereign debt crisis reforms, as well as less exposure to energy shocks and tariffs will contribute to a slight boost to the periphery's potential growth.

Although U.S. tariffs carry broad uncertainties, the general view is that they will likely weigh on European activity and inflation going forward. While those prospects may lead to expectations for a deep easing in monetary policy, ECB President Lagarde clearly stated that identifying and implementing competitive measures are reserved for legislative entities rather than the central bank. "The ECB cannot be the jack of all trades. We have to do our job, which is to procure price stability."

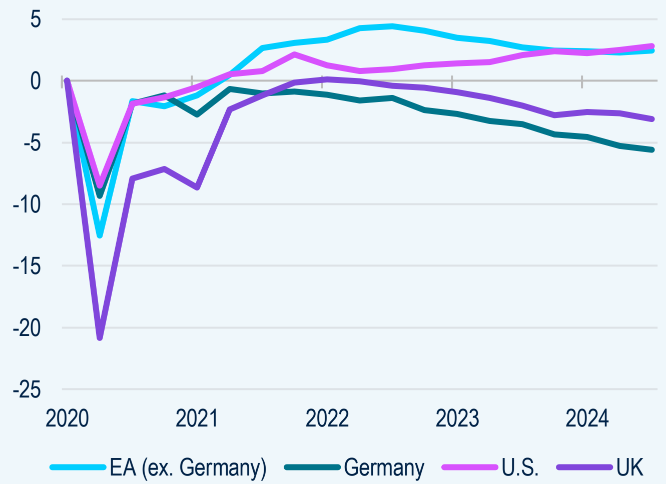
Prior to the most recent ECB meeting, the market was anticipating 150 bps of cuts in the deposit rate in 2025, whereas we were expecting 100 bps of cuts, and we're maintaining that forecast. Thus, we expect the ECB to reduce rates from 3.0% in a series of 25 bp sequential cuts that brings the deposit rate to 2% by June, which is when the ECB may pause its easing cycle.

As individual country competition accelerates, the EU-Mercosur trade pact stands as a potentially significant exception.3 The agreement is set to cover 91% of bi-regional trade from Mercosur and 99% of bi-regional trade from the EU. In doing so, Mercosur will eliminate tariffs on 72% of trade in 10 years or less, while the EU will do so on 92% of trade over the same period. For the EU, the pact represents a strategic opportunity to diversify suppliers and access valuable resources, such as food, energy, and critical minerals. For Mercosur, it may boost international competitiveness and support more sustainable economic development. Despite these potential benefits, its implementation requires a multi-year ratification process by the EU Council, EU parliament, and Mercosur countries. Furthermore, the ratification process faces stringent objections from France, Austria, and Poland on competitive concerns.

While Germany continues feeling the effects of China's expansion in the electric vehicle market, policymakers in the world's second largest economy are prepping their own series of competitive measures (see Figure 4 for

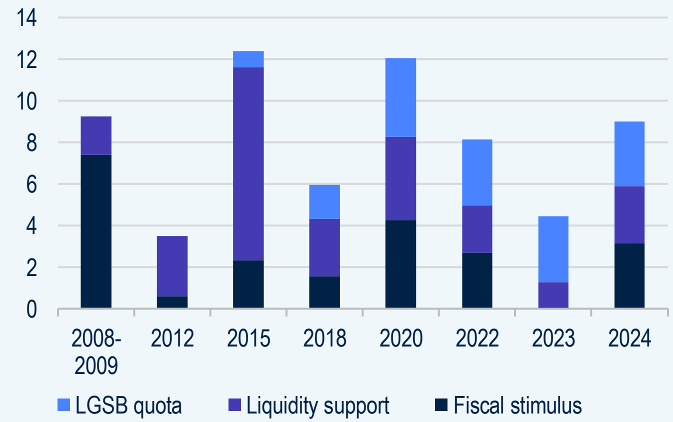
[3] Mercosur member countries include Argentina, Bolivia, Brazil, Paraguay, Uruguay, and Venezuela (suspended in 2016).

Figure 3
German economic growth has sputtered out of the pandemic.
(GDP deviation from pre-COVID trend in percentage points)



Source: Macrobond

Figure 4
China's coming stimulus could consist of a broadening mix.
(stimulus measures, % of GDP)



Source: IMF, PGIM Fixed Income as of November 12, 2024.

composition of China's recent stimulus measures). December's Politburo statement explicitly acknowledged the country's structural and cyclical headwinds as well as its need for broad based growth drivers. To that end, the Politburo gave the PBoC approval to run "moderately loose" monetary policy for the first time since the 2008/2009 financial crisis.

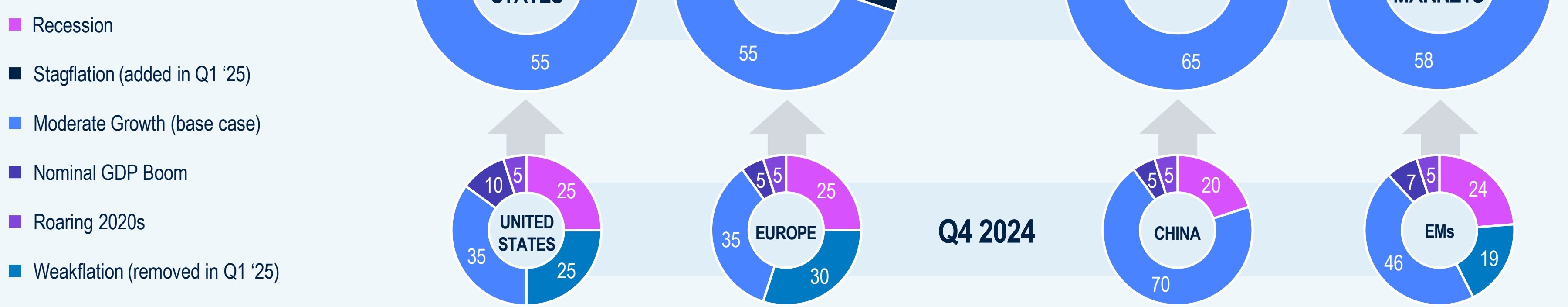
China is also seeking property market stabilization through proactive fiscal policy that includes "strengthening extra-ordinary" counter-cyclical responses to boost domestic consumption. In addition to these initial signs of social benefits, its industrial push will continue as it seeks to establish "a modern industrial system." Based on this approach, we believe Beijing may aim for a net fiscal stimulus of at least 2% of GDP in 2025.

As it seeks to revive growth, Beijing may also relax its official growth target "of at least 5%" in favor of a 4.5-5.0% range. We recently lowered our forecast for China's growth in 2025 from 4.5% to 4.2% based on the tariff uncertainty, lags in policy pass through, and the risks to achieving the growth target. We could upgrade our growth assessment if and when we observe softer implementation/effectiveness of U.S. tariffs and faster stimulus delivery in China.

Some of the symptoms of the heightened competitive landscape are apparent in Japan as well. Nominal data in Japan are consistent with a sustainable 2% inflation target amid solidifying inflation expectations and wage outlooks. Considering the domestic political uncertainty after recent elections, there are also upside risks to fiscal expansion that could put further upward pressure on domestic inflation. Furthermore, considering the passthrough of yen weakness to Japanese inflation, we now see the Bank of Japan raising interest rates in January by 25 bps on the way to 50 bps of hikes in 2025, followed by another 50 bps in 2026, which would take the BoJ's policy rate to 1.25%.

Given the heightened competition and focus on accelerating growth amongst individual economies, the distribution across our economic scenarios is generally more concentrated around the base case for moderate global growth relative to prior quarters. While we see no less than a 55% probability for moderate growth in any region, the growth risks are skewed to the upside in the U.S. and to the downside in Europe (Figure 5). Our base case of moderate economic growth in China consists of slight upside growth risks and downside inflation risks.

Figure 5
PGIM Fixed Income's Q1 '25 economic scenarios feature greater concentration around the base case relative to Q4 '24. (% probability)



Source: PGIM Fixed Income. *EM consists of a weighted average of the U.S. (35%), Europe (35%), and China (30%). EM probabilities may not sum to 100% due to rounding..

PGIM FIXED INCOME

SECTION 4

GLOBAL CREDIT RESEARCH OUTLOOK

By the Global Credit Research Team

04

CORPORATE CREDIT—THE UNDERPININGS OF HEALTHY STARTING POINTS

Positive economic growth and strong credit fundamentals underpin a healthy setup for corporate credit in 2025. As a generalization, revenue, profitability, and margin trends look relatively durable, the labor and wage backdrop continue to gradually improve from a corporate perspective (easier to hire, less wage inflation), and inventories and supply chains remain in good shape. Debt funding costs have likely crested alongside a peak in developed market interest rates and credit is widely available across the ratings spectrum, including increased scale and sophistication of private capital providers. Corporate fundamentals are certain to be influenced by policy adjustments from the incoming Trump administration, and we are particularly mindful of the second- and third-order effects of U.S. policy developments. The biggest potential spoilers to healthy credit fundamentals are shifts in the economic trajectory and global policy developments. With compressed credit risk premia and company/creditor activity being an outsized determinant of returns for stressed loans and bonds, credit selection will increasingly standout.

What Lies Beneath

Global corporate credit default rates will likely remain below long-term averages after they appeared to peak in early 2024. We expect them to stay flat or decline slightly from here unless there is a material change in economic trajectory. Global loan defaults should continue to outpace those in global high yield given the weaker ratings mix and quicker interest-rate adjustments on the floating-rate coupons (even assuming moderately lower rates). Low headline level defaults belie greater dispersion as liability management activity becomes a dominant, structural theme in global credit markets. Distressed exchange activity surged post-COVID, and the new paradigm heavily favors manager scale and capital flexibility.

Corporate Deal Activity to Accelerate

M&A continues its post-COVID recovery, and deal activity should accelerate considerably in 2025. A more favorable antitrust backdrop, growing corporate confidence, and widely accessible credit/funding markets support higher activity. Healthcare, technology, and consumer sectors could see the largest increases in activity. M&A is typically positive for high yield and loan issuers and mixed for high grade companies, which are frequently the acquirer and may represent a leveraging event. Higher M&A activity should drive a sharp uptick in net issuance, particularly in U.S. leveraged credit markets—marking a change from the past couple of years which saw healthy gross supply, but minimal net supply.

All Eyes on U.S. Policy Developments

While markets eagerly await the Trump administration's opening policy salvo, the second- and third-order effects (including global response and escalation) may have greater sector impacts. Domestically, material changes to U.S. immigration policy may impact negatively corporate access to labor, particularly in the services sector. Broad-based deregulation can be a short-term tailwind, but longer-term implications are more complex and warrant monitoring. A prominent example is a more relaxed regulatory approach toward the U.S. financial services industry.

December Credit Analyst Survey

Global credit fundamentals have retreated from post-COVID peaks, but remain strong. Corporate revenue and profitability trends appear healthy and durable, with incremental softness in European autos.

Consumers are doing just fine overall, but bifurcation continues. The lower-end consumer continues to exhibit constrained purchasing power and value-seeking behavior, while the mid- to higher-end consumer continues to benefit from real wage growth, the wealth effect, lower debt service burdens, strong employment, and improved confidence.

Global financials remain well-positioned fundamentally, benefitting from bottoming net interest income trends, higher capital markets and deal activity, and healthy underlying asset performance. U.S. financial services deregulation would provide short-term tailwinds, but may add longer-term risks.

AI remains a multi-year structural growth engine with wide-ranging implications for corporate credit. As AI-related investment filter through the real economy and into more sectors (e.g. technology, power, industrials, energy, and telco) and geographies, we expect the impact on capex and productivity will become more pronounced.

Sluggish trends persist in the global industrial manufacturing complex and consumer durables/luxury goods, largely owing to the ongoing nascent recovery in Chinese economic activity. Sectors, such as global chemicals, have cycled through inventory and found a bottom, but a rebound in activity remains elusive. The elevated nominal interest-rate environment has negatively impacted activity in autos, housing, capital goods, and telecom. Interestingly, outside of these sectors, only a small subset of our analysts identifies the cumulative effect of elevated rates as negatively affecting forward demand.

Growing oversupply of crude oil is expected to pressure global energy fundamentals, with balance sheet strength and healthy current cash flow a sizeable mitigant. Other key commodities are also providing a moderate deflationary tailwind (lumber, steel, natural gas, food-at-home), though copper & metals linked to electrification remain on an upward trajectory.

VIDEO SERIES

U.S. ELECTION SECTOR IMPACTS

With 2025 underway, we are focusing on the potential expansion of U.S. tariffs and their effect on different industries. This video series highlights the potential impact on key U.S. industries—autos, consumer goods, energy, healthcare, housing, municipals, technology, and utilities.

AUTOS

Craig Leoce, U.S. Leveraged Finance Credit Analyst

- Environment favors ICE over EV manufacturers in the near term.
- Trump may target initiatives designed to speed the process of electrification.
- Tariffs on Mexico could prompt another reimagining of the auto supply chain.

CONSUMER GOODS

Elitza Fleischman, **CPA**, U.S. Investment Grade Credit Analyst

- Tariffs would increase the cost of goods at a time when U.S. consumers are struggling.
- But price increases will be shared across supply chains, so consumers will not bear all costs.
- Most vulnerable categories: toys, sporting goods, appliances, electronics, apparel, footwear, home furnishings, and auto parts.

UTILITIES

Maxwell Hausle, **CFA**, U.S. Investment Grade Credit Analyst

- The new administration will likely roll back EPA rules, mitigating energy price increases.
- Trump has criticized the IRA. Changes to tax credit transfers or renewable tax credits may affect regulated utilities.
- Trump's platform of tariffs and lower corporate tax rates could negatively impact regulated utilities' credit quality.

From the corporate perspective, labor and wage trends continue to gradually improve (i.e. better labor availability and a more manageable wage backdrop). However, we continue to see a worsening wage picture (i.e., elevated and problematic) in the leisure/services sectors. Pricing power continues to gradually weaken, concentrated in COVID beneficiaries as excess demand mean reverts (consumer goods, retail, food/restaurants, building materials, packaging). That said, corporate profit margins appear sticky at elevated levels, and we remain biased toward slightly higher margins in 2025.

Trend score	
Positive	↗ (4 trend score)
Neutral	● (2-3 trend score)
Negative	↙ (1 trend score)

Q1 2025 U.S. and European Investment Grade Roundtable summary

Sector fundamentals

Weak ◄◄◄ ►►► Strong

	1	2	3	4
Communications	Media ●	Cable ●	U.S. & Euro telecoms ●	
Consumer		Retailers ● Restaurants ● Food/beverage ● Healthcare services ● Supermarkets ● Airlines ●	Lodging ● Consumer products ● Healthcare products ↗ Pharmaceuticals ● Tobacco ● Euro luxury goods ↙ Euro cons. products ↙	Automotive ●
Financials		Canadian banks ● Finance co's ●	U.S. money centers ● U.S. regionals ● Life insurance ● Australian banks ● Euro insurance ●	P&C insurance ● REITs ● Euro banks ●
Real estate		Euro real estate ●		
Healthcare		Healthcare services ●	Healthcare products ↗ Pharmaceuticals ●	Healthcare REITs ↗
Housing			Building materials ● Lodging ●	Residential REITs ●
Industrials & manufacturing	Euro chemicals ●	Chemicals ● Railroads ● Euro autos ●	Paper & packaging ● Aerospace/defense ● Euro aerospace & defence ↗ Euro building materials ● Euro capital goods ●	Diversified manufactures ● Industrial REITs ●
Metals & mining				Metals & mining ●
Oil & gas			Oil field services ●	Independents ● Integrated ● Refining ● Pipelines ●
Technology			Technology ● Euro media & tech ●	
Utilities & power		Electric ●	Euro utilities ● Euro infrastructure & transport ●	

Source: PGIM Fixed Income

PGIM FIXED INCOME

SECTION 5

GLOBAL SECTOR OUTLOOKS

05

DEVELOPED MARKET RATES

Outlook: Bracing for further swings and fading their extremes. The choppiness among developed market rate complexes should continue as DM central banks emphasize data dependency. We largely expect recent trading ranges to hold, thus we'll focus on central tendencies as market swings persist.

■ If we were to construct a narrative around the outlook for developed market interest rates in 2025, it would likely require some revisions in the months ahead. The swings that defined much of last year's market environment occured as developed market central bank policies gravitated towards data dependency as opposed to forward guidance. Considering that the Fed and ECB appeared to solidify that shift in their final meetings of 2024, we expect the sizable fluctuation in rate levels to persist going forward.

■ The direction and size of these fluctuations will largely depend on participants' perception of the data in the context of central bank reaction functions, particularly as individual economies seek respective ways to accelerate growth (see the Economics section for more). For example, U.S. and EA inflation readings that remain stubbornly elevated, say slightly above 2% target levels, could maintain long-term yields near the top of their respective ranges and support the recent steepening across yield curves.

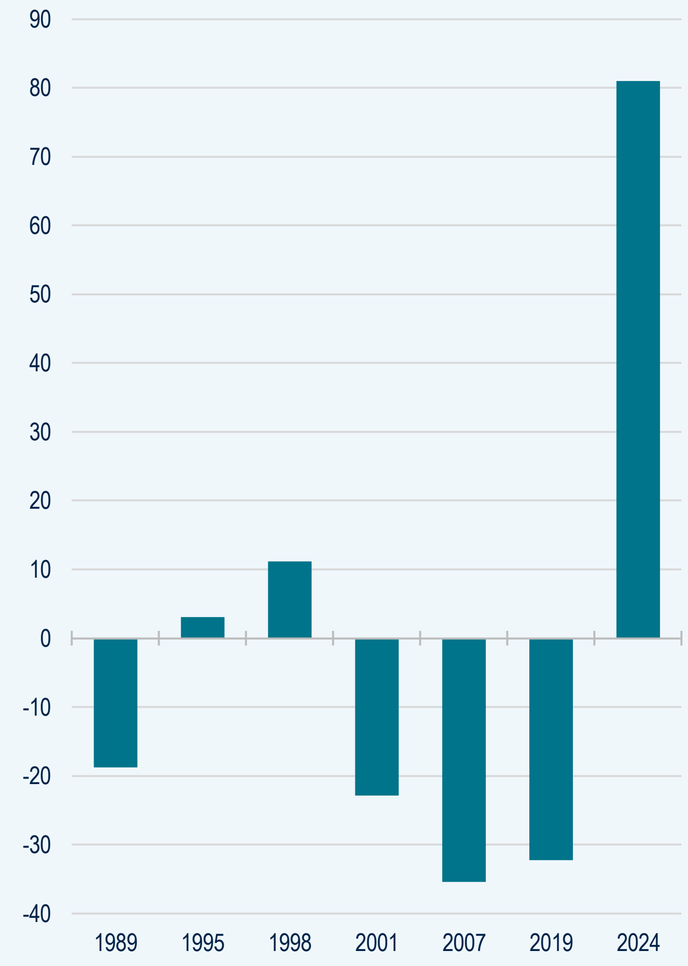
■ While much time and energy will be spent parsing the incoming economic data and reading the central bank tea leaves, last year's trading experience was informative and relatively straightforward. As such, we believe an optimal approach to navigating the developed market rates complex consists of fading the upcoming extremes of the ranges as they will likely be driven by a narrative that is also bound to fade and likely shift.

■ From a central bank perspective, the potential shifts in global trade, the relative stickiness of inflation, and overriding data dependency continues to reshape expectations. For example, prior to the most recent ECB meeting, the market was anticipating 150 bps of cuts in the deposit rate whereas we were expecting 100 bps of cuts, which is a forecast we maintained (bringing the deposit rate to 2.0% in 2025).

■ Similarly, the Fed's rate path now appears far shallower than when it launched its easing campaign with a 50 bp cut last September. In last year's final policy meeting, the Fed halved its expected rate cuts this year to only 50 bps amid terminal rate and neutral rate projections that rose to 3.1% and 3.0%, respectively. Additional increases may follow this year.

■ As conditions unfold this year, we think three 25 bps cuts by the Fed is a reasonable expectation.

While early rate cuts historically bode well for rate returns, the latest cycle stands out.
(10-year yield moves 3 months after first Fed cut of cycle, %)



Source: Bloomberg

- The shallower rate-cut trajectories along with rising terminal and neutral rate projections have contributed to steeper yield curves as long-term rates remain elevated, particularly in a historical context of rate cutting cycles (see the Figure for an example of the U.S. 10-year in the current cutting cycle).

- In terms of potential policy tightening, the Bank of Japan remains on track to hike rates by multiple times in 2025 despite what appeared to be a close call when it held rates steady in December. Given the BoJ's presumption that wage increases will come to fruition this year, we anticipate that the BoJ will lift rates by 25 bps in January and again in mid-2025, which could bring its policy rate to 75 bps by the end of 2025 with a risk that it could increase up to 1%. While the presumed rate hikes could put the front of the JGB curve at risk, the long end of the curve has sold off, creating some potential for recovery, particularly in the event that long U.S. rates rally as well.

AGENCY MBS

Outlook: Positive in the short term given valuations, dampened net origination, and possible bank demand. We prefer exposure in lower 30-year and production coupons.

- After MBS spreads widened sharply in Q4 '24, our positive near-term outlook is primarily due to current valuations, and we remain constructive over the longer term versus interest rates. Given the increase in mortgage rates, we expect net supply in 2025 to look quite similar to 2024—less than $200 billion in total net issuance, which will be very light versus Treasury and investment grade corporate issuance.
- Aside from higher primary rates, the lack of affordable housing remains a headwind for mortgage application activity. If the Fed slows the pace of rate cuts, prepayment activity is likely to remain muted. Banks could be a source of demand in 2025 as revised regulations under the Trump administration could render MBS holdings less capital-intensive. Growth in bank deposits amid the end of quantitative tightening is also likely to support the sector.
- The potential risks to our outlook pertain to the Fed, particularly if it maintains a relatively hawkish bias and the market continues to walk back rate cut expectations. Furthermore, the Fed is unlikely to stop MBS from rolling off its balance sheet and unlikely to add them again in the instance of another quantitative easing program. Finally, index-level spreads are currently not overly compelling, but zero-volatility spreads remain attractive, particularly in higher coupons.
- We prefer specified pools over TBAs for better convexity profiles and less duration sensitivity. We prefer exposure in lower 30-year and production coupons as well as adding Ginnie Mae exposure considering the recent underperformance vs. conventionals.

The sizable widening in MBS spreads in Q4 '24 support our positive view on the sector (Bloomberg MBS Index OAS, bps)

Source: PGIM Fixed Income and Bloomberg.

THE PROBLEMS WITH THE CLIMATE VALUE-AT-RISK APPROACH

In a rapidly changing world, investors need to understand the risks their investments face as a result of climate change. There are two broad types of climate risks. The first is called physical risk, which is the physical impacts of climate change and the risks posed to real assets and infrastructure. The second is called transition risks, which are those coming from the global transition towards a low-carbon economy. An example of transition risk is the transition away from internal combustion engine vehicles towards electric engine vehicles.

While there are many tools that investors use to quantify each of these risks, one that's become increasingly prevalent is called climate value-at-risk, which promises to provide insights into these risks at the portfolio level. At a high level, this tool calculates the emissions reductions required to achieve an emissions pathway and multiplies those reductions by a cost of carbon. This number can then be used to determine the cost to the company and approximate the effect on the value of an issuer's debt or equity.

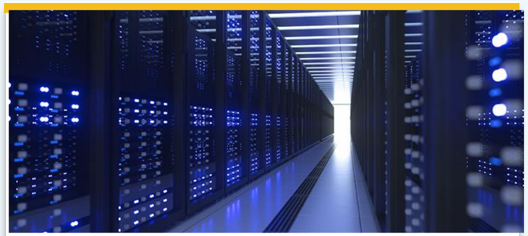
Unfortunately, there are multiple flaws with the climate value-at-risk model. First, it assumes a cost of carbon. The problem is that any assumption about carbon pricing is likely unrealistic, especially if it's an assumption that's required to achieve, for example, no more than a 1.5º rise in temperature. About 1% of emissions globally are priced above the required level, according to World Bank data, meaning that current global pricing schemes do not put a sufficiently high price on carbon to achieve the outcomes projected in 1.5º temperature rise scenarios. Another limitation with assuming a cost of carbon is that it's simplistically assumed to be a tax. In reality, it's much more politically feasible to implement subsidy support, or a combination of a subsidy and a tax, to ensure that transitioning sectors are receiving the funds necessary to lower their carbon intensity. In some sectors, such as autos, the most impactful policies often do not involve pricing at all, but rather "command and control" obligations, such as fleet emissions standards.

A third limitation to these climate value-at-risk models pertains to the way they estimate the effect on debt value. First, they assume that transition risks are not already priced into debt values. Second, climate value-at-risk models also apply one risk level across all bonds. However, this is not how fixed income instruments work. Different bonds with different maturities and levels of seniority will naturally face different levels of risk. Even if we accept that the issuer is exposed to these risks, not all debt instruments will be impacted the same.

PODCAST

A LOOK UNDER THE HOOD OF CLIMATE RISK ANALYSIS

This episode focuses on the EU autos sector as means of exploring how we leverage our bottom-up research approach to analyse climate risks.



PODCAST

POWERING DATA CENTRE EXPANSION

This episode provides a comprehensive look at data centres' energy use, the implications of this for utilities, methods of renewable energy procurement, and how companies account for this in their emissions reporting.

Moreover, they assume companies are static and can't adapt as policies tighten. They similarly assume 100% of the cost is borne by the company. Yet, some of these costs are always passed on to consumers (and nearly all the costs in certain industries, such as utilities).

With these limitations in mind, we prefer to take a more bottom-up, nuanced approach in our analysis of climate risks and their potential impacts on individual credits. Our example references the EU's automobile emission reduction targets and the potential impacts on European automobile OEMs. Beginning with the Euro 1 standards, the EU first put emissions standards in place in 1992, which have helped reduce emissions from petrol cars by about 60%. With the new Green Deal, the EU aims for an additional 15% reduction in average emissions of new vehicles by 2025, a 55% reduction by 2030, and only zero-emission vehicles by 2035.

Each OEM has been provided with a target of emissions it needs to hit, with the first material test in 2025 and then in 2030. For every gram per kilometer of emissions in excess of its targets, the OEM must pay a fine of €95 for every car it sold that year. So, depending on your assumptions, these could be quite material figures and particularly punitive for mass market manufacturers. With a small excess multiplied across a very large volume of sales within a given year, some have estimated these fines could be quite high, exceeding €10 billion. To put that into perspective, annual EBITDA for the industry is around €90 billion. So, from that perspective, these fines could certainly be material.

Of course, it is not entirely clear whether these estimates are for 2025, or 2030, or 2035. And as we saw when EU emissions standards were last tightened in 2020/21, OEMs are usually able to achieve significant improvements in a single year when nudged by regulation. So, depending on the assumptions, the expected impact could vary greatly. However, one certainty is that it will impact investor sentiment and should be a major driver of OEM credit spreads.

While meaningful, emissions targets are just one of several headwinds facing the sector. Over the past six to 12 months, European OEMs have increasingly faced challenges in the Chinese market from domestic competitors. We've also seen questions on the uptake of EVs more generally. More recently, tariff risks (both between China and the EU and between the U.S. and the rest of the world) have increased. There are also concerns about how the European economic outlook could affect demand for vehicles in Europe.

To determine which OEMs might miss their targets and to estimate potential fines, we identify the targets for each OEM and model the evolution of their fleets over the coming years. We also make assumptions around the penetration of EVs and the gap between current and target levels. One nuance is that OEMs can meet these targets in a variety of ways. The most obvious way is to sell more EVs, but OEMs can also pool with other OEMs that have an excess of emissions credits. After taking all of this into account, we end up with a rank order of names that we view as more vulnerable to fines than others.

This process often leads us to a very different conclusion than what the climate value-at-risk models produce. As one example, data from one of the largest ESG data vendors show that one of the auto manufacturers that we believe will face the highest fine of all OEMs is estimated to have a climate value-at-risk of 0 on their bonds. Vendor data do not appear to reflect the fact that these manufacturers face some of the most substantial transition risks of any sector. So, ultimately these climate value-at-risk models may not adequately reflect the nuance in the real transition regulations.

ESG is just a part of the broader credit picture. Analysts and portfolio managers consider it alongside all the other credit material factors in order to generate the desired risk-adjusted return. The complexity in the regulation and politics around ESG argues for a more considered, bottom-up approach instead of relying on more simplistic top-down tools. In terms of process, integrating ESG factors as line items into more robust financial models does a better job at capturing the complexity of climate risks and their full impact on credit.

SECURITIZED CREDIT

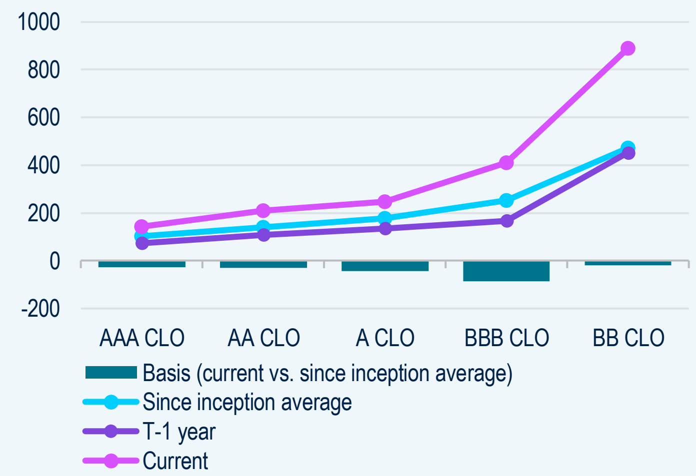
Outlook: Maintaining a high-quality focus. We continue to favor tranches at or near the top of capital structures given their attractive relative value and risk-adjusted return potential. We expect spreads to remain around historical averages, making carry the dominant theme. While solid market technicals could lead to further spread and credit curve compression, we are positioning in shorter spread duration investments. Likewise, we remain tactical and extremely selective regarding more credit-sensitive investments. Credit curves appear too flat, and the downside risks to indiscriminately allocating down the capital stack outweigh the potential rewards.

- In **CMBS**, commercial real estate pricing has been adjusting to the higher interest-rate environment, and various price indices indicate we are now at or close to the valuation trough. However, we do not anticipate a V-shaped recovery given expectations around long-term interest rates. In 2025, we expect CRE price appreciation to be flat in aggregate across property types and look for CRE transaction activity to rebound with greater clarity in valuations. Delinquency and modification activity will continue as loans reach maturity and face refinancing challenges amid lower values and higher coupon rates. We continue to see value in 5-year conduit AAA securities as spreads look attractive relative to similar tenor IG corporate bonds. Down the stack, we continue to see value in single-asset single-borrower securities and are selectively adding exposure.

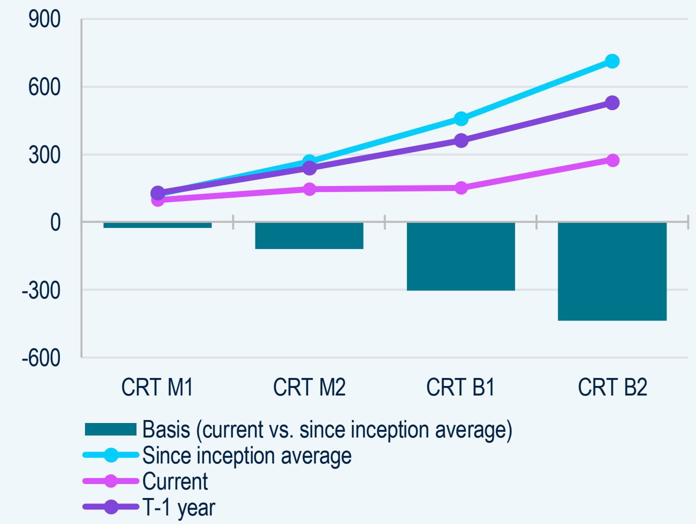
- In **RMBS**, while higher mortgage rates have weighed on affordability and demand, the growing supply of existing homes for sale remains below the long-term average, which supports home prices. We remain positive on mortgage credit instruments, as strong mortgage underwriting practices persist, although we acknowledge the uptick in delinquencies in FHA and non-qualified mortgage (non-QM) pools. We see value in reperforming loans (RPLs) and second-lien bonds given their wider spreads over corporates and other non-agency securitized products. Despite our positive view on mortgage credit, valuations of credit risk transfer bonds (largely from Fannie/Freddie mortgages) are stretched as spreads rallied significantly in 2024.

- Senior **CLO** tranches continue to offer attractive relative value compared to many fixed income asset classes despite the ongoing rally in spreads. We remain cognizant of potential credit risks in the underlying bank loans, which could outweigh prevailing technical support for CLOs. Further, while bank loan spreads have been supported by low net supply and strong demand, we expect to see some credit deterioration in the underlying CLO collateral via downgrades to CCC, increased default rates, and lower recovery rates. Thus, we continue to favor senior CLO tranches in the U.S. and in Europe.

CMBS credit curve (OAS bps, Treasury)



RMBS credit curve (OAS bps, Treasury)

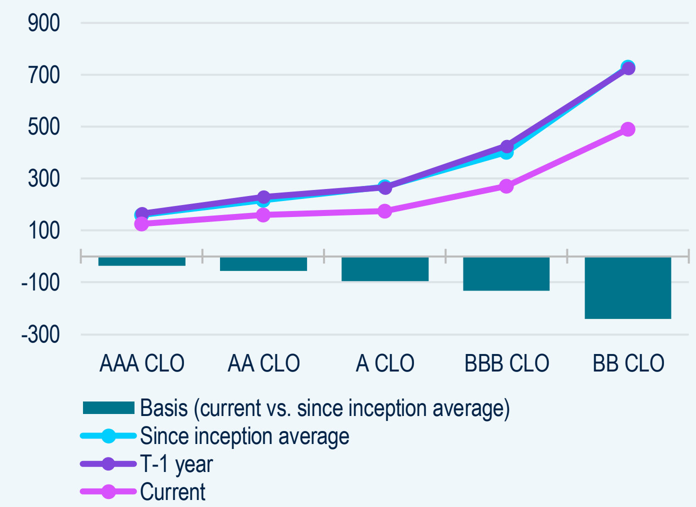


Sources: JPMorgan. Dates January 3, 2012 to December 11, 2024. RMBS Credit Curve. SI: CRT M1/M2: January 3, 2017; CRT B1: February 28, 2017 and CRT B2: January 4, 2021

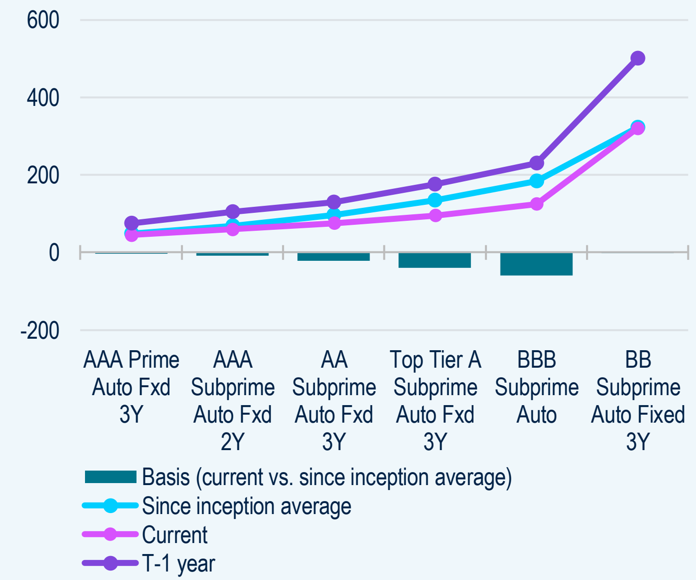
We are selectively adding in new issue mezzanine tranches where we see additional carry opportunities. In the U.S., we find value in selling higher premium / longer duration bonds and rotating into spread neutral primary transactions. In Europe, the opportunity to purchase bonds at a discount offers a degree of total return potential..

- In **ABS**, while prime consumer credit remains resilient, the effects of inflation and lower disposable income continue to weigh on the weakest consumer segments and are starting to weigh on the near-prime segment. A declining inflationary and interest-rate environment could be beneficial, but this will take time. Thus, we continue to watch for signs of consumer credit weakening more broadly. We remain positive on spreads in the near term, but are mindful of heavy supply headwinds. We favor top-tier unsecured consumer and subprime auto issuers, as well as significant risk transfers (SRTs) as they provide exposure to high-quality consumer assets.

CLO credit curve (OAS bps, SOFR)



ABS credit curve (OAS bps, Treasury)



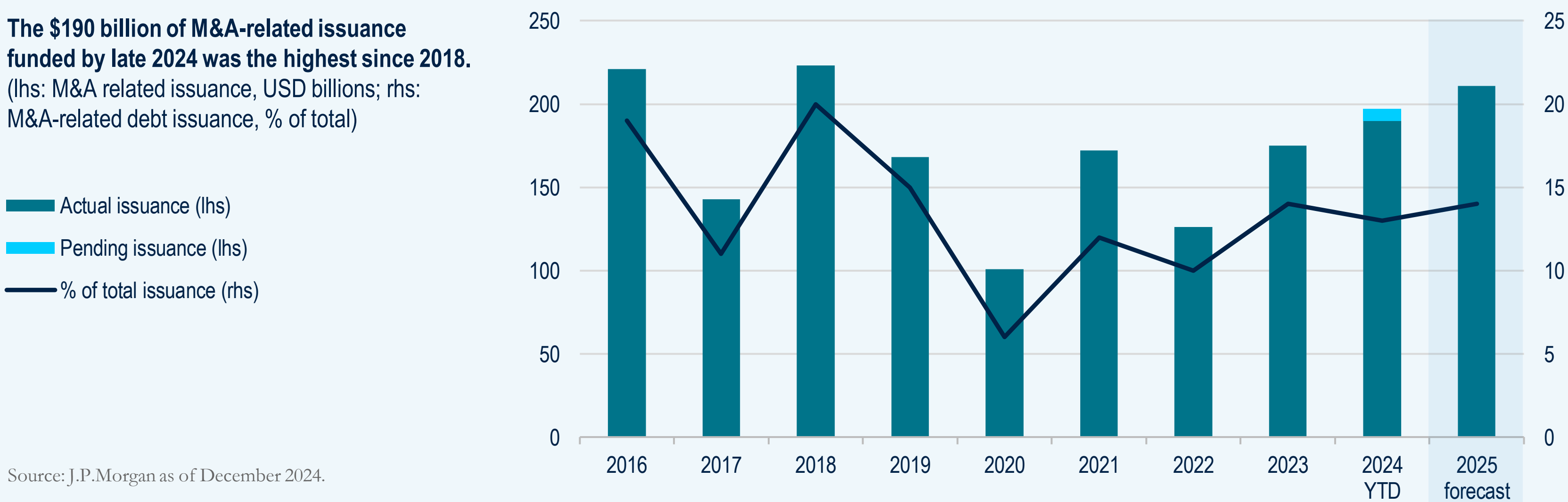
Sources: PGIM Fixed Income and JPMorgan

INVESTMENT GRADE CORPORATES

Outlook: Emphasizing stable carry. While global IG corporate spreads sit near multi-decade tights, all-in yields remain attractive as demand from asset allocators continues to drive inflows, providing a positive technical backdrop. Although yields have helped compress spreads, the path to strong excess returns over the next twelve months is a narrow one. Our outlook is based on the implementation of U.S.-centric policies and the respective competitive measures occurring beyond the U.S.

- In the U.S., our base case economic scenario, in which the U.S. posts moderate economic growth and the Fed gradually cuts, sees the corporate index widening moderately before settling around an OAS of about +90 bps. We believe the mix of policies proposed by the Trump administration will allow the positive aspects (e.g., reduced corporate tax rates and deregulation) to balance the more negative aspects (e.g., tariffs and immigration constraints). Subsequent strong growth or rising inflation could lead the Fed to slow the pace of rate cutting (beyond its December '24 projections) and prompt a widening of IG spreads. Ultimately, based on the order of policy rollouts post-inauguration, we could see an uptick in volatility.
- In terms of fundamentals, credit ratings remain positive. Q3 2024 revenue growth improved at 3.9% YoY (excluding commodities) and EBITDA grew 2.5% (YoY), the most in six quarters (J.P. Morgan). Although leverage has increased, it is stabilizing QoQ. In addition, the leverage gap between BBB and A-rated issuers is narrowing. As is typical at the start of a new year, earnings expectations are elevated, but those may moderate going forward.
- The previously suppressed impetus to seek growth via M&A is likely to rise in industries, such as healthcare & pharmaceuticals, technology, food & beverage, TMT, and even regional banks. While the composition of M&A financing matters greatly, we note that management teams have been disciplined in maintaining strong balance sheets, which we expect to continue.
- Technicals appear mixed. High gross issuance in 2024 is expected to carry over into 2025 ($1.5 trillion to

The $190 billion of M&A-related issuance funded by late 2024 was the highest since 2018.
(lhs: M&A related issuance, USD billions; rhs: M&A-related debt issuance, % of total)



Source: J.P.Morgan as of December 2024.

$1.6 trillion). A softer macro backdrop could lead to some supply indigestion. January and February are likely to be heavy supply months (which could be volatility inducing). On the upside, we are likely to see a decline in net supply by $100 to $200 billion (YoY) due to maturities in 2025 and coupons.

- As for U.S. portfolio positioning, valuations are generally flat, with notable spread compression in 10-year BBB- rated bonds vs. A-rated bonds. As a result, conditions are not overly favorable for maintaining more beta in our portfolios. We will look to utilize 10% to 30% of our risk budget and to maintain an underweight in spread duration, particularly at the back end (longer-dated securities) where valuations appear rich. Although the "Big 6" money center banks have outperformed the index, we will continue to lean into carry trades and allocate to securitized products where possible.

- On the European side, the positives are limited, but the economy has held up well and corporate fundamentals are solid. With ECB rate cuts expected through June, we believe the risk of significant downside economic misses are more tail risk than base case (although not negligible). Issuance is expected to remain neutral in 2025 with a gentle increase in net supply.

- Information ratios on spread direction remain relatively low. However, after European spreads tightened notably in Q4 and 2024, we expect rangebound levels with a widening bias as 2025 progresses. While spreads are near recent tights on an OAS basis, we are a long way off on a mid-swap basis due to the recent collapse in swap spreads. The move in swap spreads has been dramatic, and, as a result, sovereign, supranational, and agency issues look cheap on a mid-swap basis.

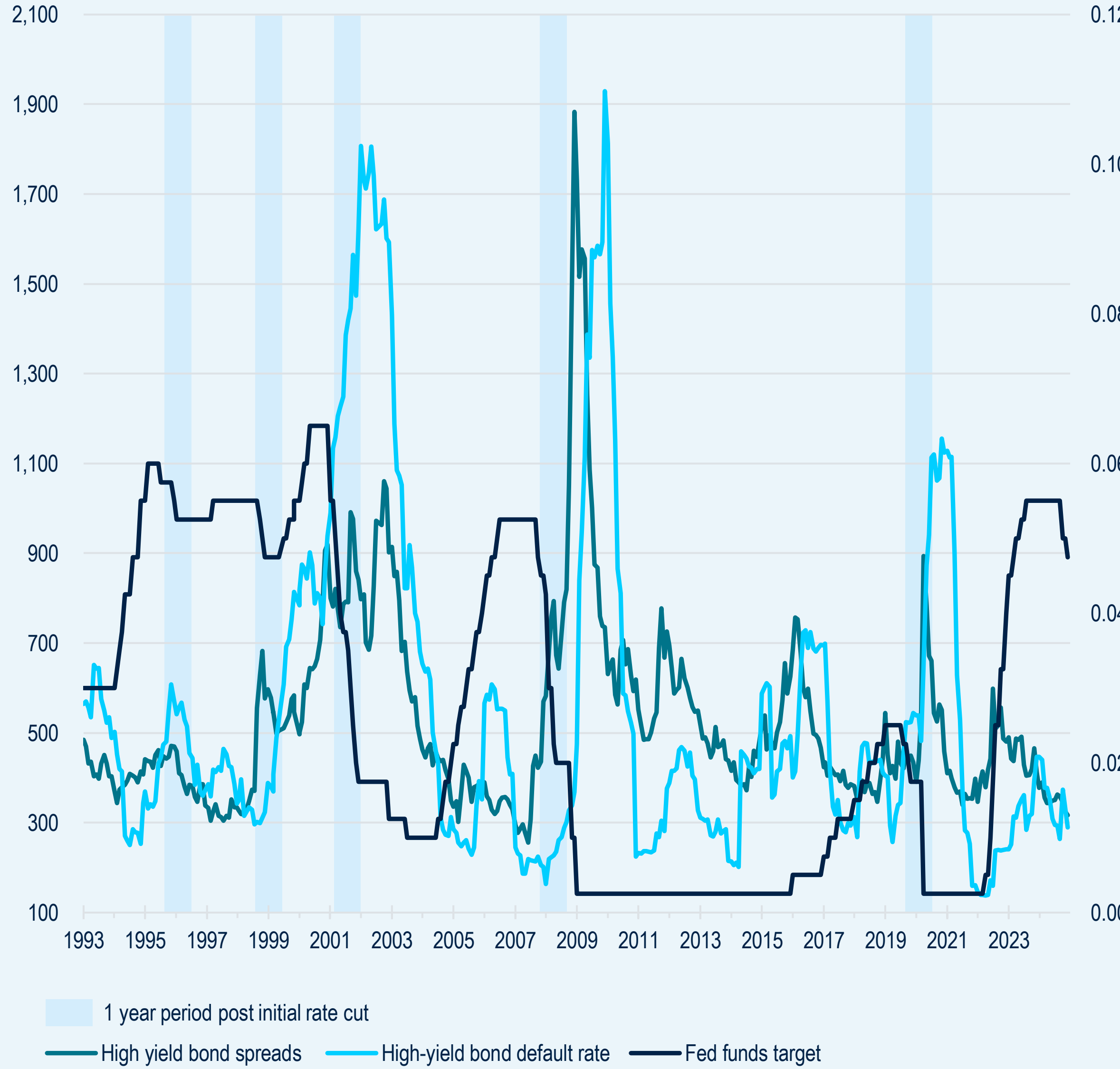
- In our Euro IG portfolios, we continue to cut risk as spreads have rallied. Currently, our overweight to market risk is at a five-year low. In addition, we are neutral on spread duration. We are similarly positioned, from a risk perspective, in our global IG portfolios with a small underweight in spread duration and moderate skew toward more risk on Euro side of the portfolio. This reflects better carry opportunities rather than a belief that spreads will compress further.

GLOBAL LEVERAGED FINANCE

Outlook: On solid ground. The high yield market starts 2025 with a net-supply deficit, attractive absolute yields, and an overall robust credit environment. However, we continue to believe that certain notable risks, e.g., geopolitics, are not sufficiently reflected in current spreads. As such, we maintain our close-to-home defensive positioning with an underweight to spread duration, but a spread-carry at, or close to, benchmarks.

- High yield bond spreads entered the new year within striking distance of the all-time tights achieved prior to the GFC. With the "Trump trade" in full swing, we've observed an uptick in C-suite bullishness and optimism, which bodes well for the U.S. economy, corporate profits, and asset prices. Further, should economic conditions deteriorate, the potential for a central bank "put" should help to mitigate uncertainty (see Figure).
- Defaults should fall below 1.5% in 2025, justifying current spread levels. Indeed, while we expect fewer rising stars and increasing net issuance this year, we believe technicals should remain supportive as direct lending and broadly syndicated loans take share. We also believe the maturity wall is manageable over the near term.
- While optimistic overall about the fundamental outlook, our positioning is less bullish due to current valuations, uncertainty surrounding the Trump administration, and heightened—albeit easing—geopolitical risk.

High yield spread and default rate changes near Fed Funds rate cuts
(lhs: spread-to-worst, bps; rhs%)



Source: J.P. Morgan

- We are overweight short duration bonds and have positions in AAA CLOs for high-quality carry in place of longer-duration, high-quality issuers. Looking at sectors, we remain overweight home construction and electric/independent power producers and have added opportunistically to healthcare providers and specialty finance companies. Recent reductions have included building products and midstream energy.

- With a 9% total return and more than 60 bps of tightening, U.S. leveraged loans closed out 2024 better than expected. We expect a strong start to 2025, as large volumes of cash from year-end amortization paydowns and strong recent ETF inflows should keep demand high. That said, we believe defaults will likely continue to drift higher to between 4% and 5%, largely driven by LME activity, which shouldn't materially impact overall market prices.

- Following 2024's outperformance, we see another solid year ahead with a leveraged loan total return forecast of 6.5% in 2025. Our forecast is supported by high all-in current coupons and yields, strong CLO formation, and continued inflows from institutional and retail investors. However, sharply higher net new issuance volume and easing SOFR rates (thus declining coupon rates) could ultimately weigh on total returns.

- We continue to favor public BB and high B loans over sponsor-owned, low-B and CCC loans as we expect those lower-quality facilities will be challenged by the fundamental backdrop. We believe that credit selection and deep, fundamental credit research/modeling is becoming increasingly important. To that end, avoidance of defaults will likely be the biggest driver of alpha over the next 12-24 months.

- Spreads on **European high yield** and **European loans** tightened further through the end of 2024 as markets rallied following the U.S. elections results. With market technicals supportive but spreads broadly at fair-value, we anticipate spreads will remain rangebound in early 2025 barring any unforeseen shocks. With yields attractive on an absolute basis, we expect high yield bonds and loans to generate positive excess returns over the next 12 months on a probability-adjusted basis for the various economic scenarios outlined in our economics section. Further, we believe defaults will likely remain around current levels over the same time, as the vast majority of the market consists of high-quality, performing businesses.

- In terms of positioning, we remain underweight cyclical businesses given the weak European industrial backdrop and uncertainty regarding U.S. tariffs. We are running market-neutral levels of risk given our view that spreads are roughly at fair value and strong technicals are likely to persist. Indeed, we believe issuance will be easily absorbed going forward. Careful credit selection and a focus on relative value opportunities will likely be rewarded. In the secondary market, investors will likely remain focused on idiosyncratic credit stories to generate alpha.

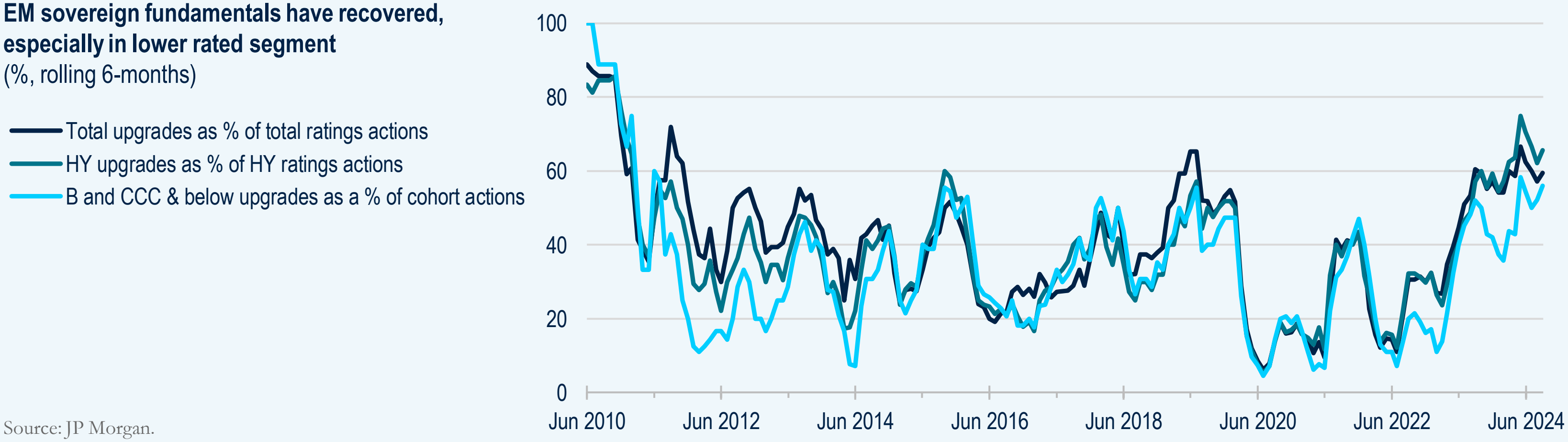
EMERGING MARKET DEBT

Outlook: Seeing opportunities in EM spreads, rates, and FX given the sector's diversity and dispersion in the context of our base case for moderate global economic growth. However, we remain measured in overall risk taking considering the macro uncertainties. Notwithstanding tight spreads, attractive yield levels and resilient fundamentals support the asset class, and performance dispersion within and between EMD sectors provides opportunities to generate alpha. We continue to favor a barbell of EM credit across the ratings spectrum where we find value. In EM rates and EMFX, we are more selective with a focus on relative value. We remain focused on fundamentals, particularly fiscal, FX, and financing vulnerabilities.

EM Hard-Currency Sovereigns

- EM hard currency once again performed well relative to other EMD sectors in 2024, and EM high yield specifically outperformed most fixed income asset classes. While top-down global macro themes and defensive investor positioning clearly set the contextual tone, country-specific fundamental factors drove the relative performance. The drivers of that outperformance are likely to moderate in 2025. Spreads have tightened further, and (outside of distressed issuers) the potential for additional compression is muted. Yet, this is not to suggest that spreads are overvalued. Rather, it reflects that broad fundamentals are on an improving trajectory (particularly for higher-yield and distressed issuers) with few signs of major sovereign defaults in the near term (see Figure below).
- In a macroeconomic environment of on-trend (or potentially below-trend) growth and fairly-valued U.S. Treasury yields, carry is likely to be the primary driver of returns within dollar-denominated fixed income. Even with the material spread tightening seen over the past year, elevated EM yields offer amongst the highest yields across public fixed income. Starting yields have historically been the leading indicator of performance and, at about 7.7%, index yields haven't been this high for 15 years, which marked an especially strong period for EM returns.
- Beyond attractive carry, several additional factors should support hard currency EM debt going forward. Emerging markets continue to lead global growth (even when excluding China), and a strong U.S. economy will likely be supportive. We forecast EM growth in 2025 to

EM sovereign fundamentals have recovered, especially in lower rated segment
(%, rolling 6-months)



Source: JP Morgan.

outpace DM growth by 2.7 percentage points and EM ex-China growth to outpace DM growth by 2.1 pps. Historically, a growth differential of 2 pp or more has translated to EM outperformance over developed markets.

■ Instead of reaching for high-beta risk, we are looking to out-yield the index while remaining conservative. Our positioning exposure remains greatest in BB sovereign, quasi-sovereign, and corporate issuers with high carry and strong fundamentals. We round out positioning with overweights in BBB issuers and some stressed-performing issuers that are more idiosyncratic in nature with attractive risk-reward profiles.

■ We continue to apply a bottom-up approach to allocating across countries as a global trade shock presents a real risk that could reduce flows in many EMs. We highlight that emerging markets, both inclusive and exclusive of China as well as the Euro area, comprise a significant share of global trade, and many of these countries will react to a new tariff regime. Our thesis of trade tensions driving a reorganization of supply chains away from adversaries and to allies will create EM winners. Many countries have benefitted from these reshoring investment flows, and this underscores how integrated EMs—including counties in Latin America, CEE, and Asia—have become with the economies of their main trading partners. Ascertaining the potential downside risk in these names is critical. We are also mindful of accumulated debt levels in some countries. These risks and others in the tails of the distribution warrant our moderate levels of risk taking.

■ That said, a de-escalation of the wars in Ukraine and the Middle East would provide some relief to geopolitical pressures that have persisted for years.

EM Corporates

■ While EM corporate spreads have compressed to historically tight levels, fundamentals are resilient. The bond maturity wall of 2026/27 has been extended via an active new issue market, and we expect EM corporate high yield defaults to remain within the historical range of 3-4%, or in line with developed markets. Even though gross issuance has been somewhat higher than expected, net supply is still deeply negative.

■ EM corporates continue to offer opportunities to diversify, and we expect any spread weakness to be short-lived given the attractive yields and resilient fundamentals. The asset class has experienced fewer idiosyncratic surprises, and non-dedicated investors have shown appetite for the asset class given the spread pick-up. Near-term technicals could weaken somewhat on heavier supply and/or news of additional tariffs on China and Mexico, but the underlying bid for yield remains strong, and we expect spreads to revert to tighter levels. Importantly, net financing is negative as more EM corporate debt is being paid down than there is new issuance.

■ We still see the best value in EM corporate BBs and select longer-dated BBB issuers. We have been reviewing our Brazil corporate holdings for risks from higher local rates/weaker FX and have also been stress-testing our Mexican holdings for additional tariffs. At this point, these risks appear manageable.

■ Risks to the asset class include any sustained U.S. dollar strength and/or a slowdown in global growth.

EM Local Markets

■ We are cautiously optimistic on EM duration and expect a wide dispersion among countries due to idiosyncratic factors. At the index level, we expect rangebound to slightly lower yields and steeper curves in Q1 2025. A lack of support from further monetary easing, where applicable, amounts to a meaningful headwind for the asset class.

■ With a few exceptions, most EM central banks are at the end of their cutting cycles, and it would require a major change in top-down factors for the curves to price in additional cuts. That said, the exceptions include countries facing tariffs and the resulting growth shock. Fiscal policy is likely to take a central stage in many countries in Latin America and also in Indonesia, China, and South Africa.

■ Brazil and Turkey will be outliers. Brazil's central bank has embarked on a hiking cycle and is now set to accelerate its rate hikes. Meanwhile, Turkey is about to start an easing cycle (see the Global Macroeconomic Research for more on China).

- In Latin America, fiscal policy differentiation will be a key distinguishing feature across countries. We are overweight Mexico (amid expectations the central bank will accelerate its cutting cycle in February) and Peru with a curve steepening bias. We are underweight Colombia and Brazil, particularly at the front end of their curves. In Central Europe, the Middle East, and Africa, we are overweight Czech and Hungary. We are underweight Poland amidst the monetary policy differentiation theme. We are overweight South Africa with a flattening bias and expect the bonds to outperform swaps. In Asia, we are overweight India, Thailand, Indonesia, and China due to disinflation and a general softness in activity data.

EMFX

- Currency dynamics are likely to be shaped by factors already identified as relevant to the wider EM asset class, including U.S. interest rates and Fed expectations. Potential performance of U.S. growth coupled with relatively high U.S. interest rates points to a small, long U.S. dollar bias against select low-carry currencies in Asia and Europe.

- We believe Asia (led by CNY) will be particularly impacted by U.S. trade policy. Therefore, we prefer to be underweight CNY, TWD, and KRW. We will need to see whether tariffs (as well as the nature of those tariffs) get imposed on other countries/regions, such as the European Union, Mexico, and Canada. We would expect a less-hawkish approach towards Mexico and Canada than the European Union. Therefore, we retain a small long in MXN and a short in Europe. From a macro and trade policy standpoint, LatAm is less at risk (see the Economics section for more on the Mercosur trade pact). Within our regional positioning, we retain a long in LatAm and MEA and a short in Europe and Asia. In 2025, we believe China would need to introduce aggressive stimulus that more than offsets the negative effects from tariffs in order to produce a positive feedback loop in EMFX.

- EM fundamentals will also impact performance. Turkey and Egypt will continue to be driven by idiosyncratic factors and, for the time being, these factors are positive (tight monetary policy, improving inflation). In South Africa, we need to see more reforms for the positive story to continue. In Brazil, the market is demanding more fiscal action amid erratic price action, and we believe this could be a turnaround story in 2025 given the level of risk premium in the market. In Mexico, prices already reflect elections and judicial reforms with U.S. trade policy a key uncertainty. Should U.S. trade policy prove more pragmatic, Mexico could outperform. We are long all five currencies (TRY, EGP, ZAR, BRL, MXN).

- Despite its challenges, EMFX could become more attractive as the year progresses. Risks to the U.S. dollar could come from a weaker domestic labor market. In this case, the current relatively hawkish repricing of the Fed could reverse, and we would aggressively, but selectively, reduce/eliminate our low carry short positions in Europe (CZK, EUR) and Asia (THB, SGD, TWD). In addition, aggressive China stimulus would likely boost industrial commodities, benefitting commodity exporters (ZAR, CLP, BRL). Similarly, a more pragmatic/transactional U.S. trade policy could present opportunities to fade U.S. dollar strength.

MUNICIPAL BONDS

Outlook: Early optimism. The Fed's easing cycle and reinvestment activity are expected to support healthy demand. However, given the Fed's data dependence, a shallower (or paused) rate-cut trajectory could pressure flows. Moreover, the new administration may introduce or discuss policies that could affect technicals. If talks of ending tax-exemption heat up, it could pull issuance forward from private issuers, hospitals, and private universities. After Q1, technicals are expected to become more challenging as net supply turns positive.

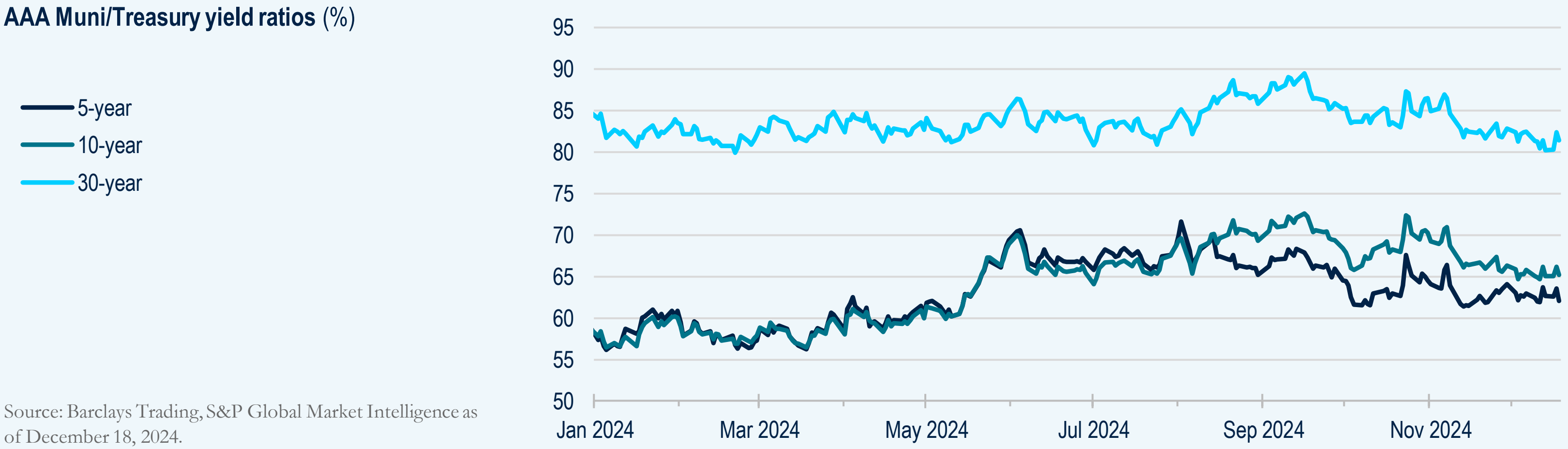
- Muni credit fundamentals are sound, with defaults remaining low and no signs of deterioration ahead. Rainy day funds remain near record highs and healthy GDP growth should propel revenues. From a ratings perspective, upgrades continue to outpace downgrades by a moderating, but healthy, margin. Excluding school districts, Moody's has given almost every sector a "stable" rating.

- In terms of technicals, rising project costs will likely lead to higher issuance. The average supply estimate for 2025 is ~$500 billion. Although this is flat to 2024, net supply is expected to be much higher, coming in around $105 billion, compared to $44 billion in 2024. Still, with $7 trillion on the money market sidelines, we expect supply to be easily digested in Q1. In terms of reinvestment, January and February will likely be strong months, despite reinvestment levels being less than 100%. Banks have been reducing their holdings in the muni sector (down 12.5% in 2024). On the taxable side, muted estimated supply (~$40 billion) should continue to be a fairly supportive technical in 2025..

- Valuations are on the rich side, with spreads near their 52-week tights. In addition, M/T yield ratios are rich— particularly beyond the 10-year, which currently hovers around 81%. This is low based on the five-year historical average of 91%. Meanwhile, with tax-exempt/taxable muni yield ratios also appearing rich vs historical averages, we expect BABs calls to continue at their current pace of ~ $1 billion per month into 2025.

- On the taxable side, muted estimated supply (~$40 billion) will continue to be a fairly supportive technical in 2025.

AAA Muni/Treasury yield ratios (%)



Source: Barclays Trading, S&P Global Market Intelligence as of December 18, 2024.

- The policies of the incoming Trump administration appear to have mixed benefits. For example, lower taxes will likely reduce the demand for munis from individuals and corporations, while tariffs and deregulation could boost state and local revenues.

- Furthermore, a potential surge in costs due to inflation (estimated to be a 1% addition to CPI) could benefit some toll road collection formulas and tobacco settlement bonds tied to CPI. Meanwhile, a repeal of tax exemption to offset federal spending, would only amount to $40 billion per year. That stated, it could lead to sizable dislocations across the sector.

- In terms of positioning, there is still significant slope out past 15-years on the yield curve, which will augment performance from a carry and roll perspective. However, with rich valuations, we believe it is prudent to limit spread duration (even with the fundamental tailwinds of an economic soft landing). As a result, we favor a barbell approach between short credit risk and longer high-quality paper in a range bound interest-rate environment, which we are expecting while the Fed continues to gradually ease policy.

PGIM FIXED INCOME

SECTION 5

SUMMARIES

05

SUMMARY OF OUTLOOKS & ASSET CLASS VIEWS

This summary consists of our short- and long-term (1-yr) sector outlooks. The latter is based on a scale of 1-10 and indicates our expectation for the sector's excess return relative to its broader, regional fixed income market (which is assigned its own 1-10 market score in the box to the right). A sector score of 1 represents an expectation for it to vastly underperform the market, and 10 indicates an expectation for the sector to vastly outperform the market.[1]

NEGATIVE VIEW — POSITIVE VIEW

Market Scores

U.S.	Europe
EM	

Sector	Short-term Outlook		
DM Rates	Bracing for further swings and fading their extremes. The choppiness among developed market rate complexes should continue as DM central banks emphasize data dependency. We largely expect recent trading ranges to hold, thus we'll focus on central tendencies as market swings persist.	U.S. Europe	UK Japan
Agency MBS	Positive in the short term given valuations, dampened net origination, and possible bank demand. We prefer exposure in lower 30-year and production coupons.	Agency MBS	
Securitized Credit	Maintaining a high-quality focus. We continue to favor tranches at or near the top of capital structures given their attractive relative value and risk-adjusted return potential. We expect spreads to remain around historical averages, making carry the dominant theme. While solid market technicals could lead to further spread and credit curve compression, we are positioning in shorter spread duration investments. Likewise, we remain tactical and extremely selective regarding more credit-sensitive investments. Credit curves appear too flat, and the downside risks to indiscriminately allocating down the capital stack outweigh the potential rewards.	CMBS CLOs	ABS
Global IG Corporates	Emphasizing stable carry. While global IG corporate spreads sit near multi-decade tights, all-in yields remain attractive as demand from asset allocators continues to drive inflows, providing a positive technical backdrop. Although yields have helped compress spreads, the path to strong excess returns over the next twelve months is a narrow one. Our outlook is based on the implementation of U.S.-centric policies and the respective competitive measures occurring beyond the U.S.	U.S. Corps. 1-10 U.S. Corps. 10+	European Corps. 1-5 European Corps. 5+
Global Leveraged Finance	On solid ground. The high yield market starts 2025 with a net-supply deficit, attractive absolute yields, and an overall robust credit environment. However, we continue to believe that certain notable risks, e.g., geopolitics, are not sufficiently reflected in current spreads. As such, we maintain our close-to-home defensive positioning with an underweight to spread duration, but a spread-carry at, or close to, benchmarks.	U.S. High Yield 1-5 U.S. High Yield 5+ U.S. Leveraged Loans	Euro High Yield BB Euro High Yield B and below Euro Leveraged Loans
EM Debt	Seeing opportunities in EM spreads, rates, and FX given the sector's diversity and dispersion in the context of our base case for moderate global economic growth. However, we remain measured in overall risk taking considering the macro uncertainties. Notwithstanding tight spreads, attractive yield levels and resilient fundamentals support the asset class, and performance dispersion within and between EMD sectors provides opportunities to generate alpha. We continue to favor a barbell of EM credit across the ratings spectrum where we find value. In EM rates and EMFX, we are more selective with a focus on relative value. We remain focused on fundamentals, particularly fiscal, strong dollar, and financing vulnerabilities.	Sov. Hard Currency IG Sov. Hard Currency HY Local rates[2]	EMFX[2] Corps. IG Corps. HY
Municipal Bonds	Early optimism. The Fed's easing cycle and reinvestment activity are expected to support healthy demand. However, given the Fed's data dependence, a shallower (or paused) rate-cut trajectory could pressure flows. Moreover, the new administration may introduce or discuss policies that could affect technicals. If talks of ending tax-exemption heat up, it could pull issuance forward from private issuers, hospitals, and private universities. After Q1, technicals are expected to become more challenging as net supply turns positive.	Taxable	

[1] The positioning in a respective portfolio may not be identical to the long-term ratings. The ratings and information herein is for comparison purposes.
[2] The scores on the indicated asset classes are on an absolute basis; i.e., the expectations for risk-adjusted market returns are embedded within the asset class specific returns.

Sector		Subsector	Spread change (bps) Q4	YTD	SOFR OAS 12/31/24
CMBS	CMBS: Conduit AAA	First-pay 10-year	-14	-35	123
	CMBS: Conduit BBB-	BBB-	-28	-389	530
	CMBS: SASB –Sr.	AAA	-15	-65	135
	CMBS: SASB – Mezz	BBB-	-25	-25	255
	CMBS: Agency Multifamily	Senior	-2	-8	89
Non-Agency RMBS	Legacy	RPL Senior	-9	-33	139
	Legacy	'06/'07 Alt-A	-15	-30	230
	GSE Risk-Sharing	M2	-20	-70	140
CLOs	CLO 2.0	AAA	-10	-38	124
	CLO 2.0	AA	-5	-70	155
	CLO 2.0	BBB	-20	-155	270
ABS	Unsecured Consumer Loan ABS	Seniors	-20	-63	118
	Unsecured Consumer Loan ABS	Class B	-35	-163	488
	Refi Private Student Loan	Seniors	-20	-63	123
	Credit Card ABS	AAA	-12	-33	58

Source: PGIM Fixed Income.

	Total Return (%)		Spread Change (bps)		OAS (bps)
	Q4	YTD	Q4	YTD	12/31/24
U.S. Corps.	-3.04	2.13	-9	-19	80
European Corps.	0.87	4.74	-15	-36	102

Source: Bloomberg.

	Total return (%)		Spread / yield change (bps)		OAS (bps)/ yield %
	Q4	YTD	Q4	YTD	12/31/24
EM Hard Currency	-1.94	6.53	-36	-59	325
EM Local (Hedged)	-0.74	3.77	+28	+20	6.39
EMFX	-4.69	-1.08	+154	-72	8.21
EM Corps.	-0.80	7.63	-23	-71	241

Source: J.P. Morgan.

	Total return (%)		Spread change (bps)		OAS/ DM (bps)
	Q4	YTD	Q4	YTD	12/31/24
U.S. High Yield	0.17	8.19	-8	-36	287
Euro High Yield	2.00	9.14	-39	-81	318
U.S. Leveraged Loans	2.29	9.05	-34	-63	475
Euro Leveraged Loans	2.01	9.17	-11	-73	472

Source: ICE BofAML and Credit Suisse.

	Total return (%)	
	Q4	YTD
High Grade Tax-exempt	-1.22	1.05
High Yield Tax-exempt	-1.08	6.32
Long Taxable Munis Agg. Eligible	-4.89	0.04

Source: Bloomberg. Represents the Bloomberg Municipal Bond Indices.

IMPORTANT INFORMATION

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of January 2025.

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EUROPEAN INVESTMENT GRADE CORPORATE BONDS

Bloomberg European Corporate Bond Index (unhedged): The Bloomberg Euro-Aggregate: Corporates bond Index is a rules-based benchmark measuring investment grade, EUR denominated, fixed rate, and corporate only. Only bonds with a maturity of 1 year and above are eligible.

U.S. HIGH YIELD BONDS

ICE BofAML U.S. High Yield Index: The ICE BofAML U.S. High Yield Index covers US dollar denominated below investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, and at least one year remaining term to final maturity as of the rebalancing date.

EUROPEAN HIGH YIELD BONDS

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

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U.S. SENIOR SECURED LOANS

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

EUROPEAN SENIOR SECURED LOANS

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

EMERGING MARKETS U.S.D SOVEREIGN DEBT:

J.P. Morgan Emerging Markets Bond Index Global Diversified: The Emerging Markets Bond Index Global Diversified (EMBI Global) tracks total returns for U.S.D-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, and Eurobonds. It limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts of debt outstanding. To be deemed an emerging market by the EMBI Global Diversified Index, a country must be rated Baa1/BBB+ or below by Moody's/S&P rating agencies. Information has been obtained from sources believed to be reliable, but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval.

EMERGING MARKETS LOCAL DEBT (UNHEDGED)

J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index: The Government Bond Index-Emerging Markets Global Diversified Index (GBI-EM Global) tracks total returns for local currency bonds issued by emerging market governments.

EMERGING MARKETS CORPORATE BONDS

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

EMERGING MARKETS CURRENCIES

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

MUNICIPAL BONDS

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

U.S. TREASURY BONDS

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

MORTGAGE BACKED SECURITIES

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

COMMERCIAL MORTGAGE-BACKED SECURITIES

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

U.S. AGGREGATE BOND INDEX

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