Market Outlook

In this edition of Prudential Fixed Income’s Quarterly Outlook, Robert Tipp, Chief Investment Strategist, looks at the outcome of past Fed hiking cycles, other sources of volatility that surfaced in Q3, and the opportunities that have emerged within the fixed income markets (page 3).

Jürgen Odenius, Prudential Fixed Income’s Chief Economist, provides his global view of the economy, examining the likelihood of QE expansion in the Euro area, why the Japanese economy continues to struggle, and the impact of China’s slowdown on the global economy (page 6).

Sector Views

**Corporate Debt (p. 8):** Given wider spread levels and healthy fundamentals, we are positive on the corporate market, favoring U.S. financial issuers.

**Global Leveraged Finance (p. 9):** We believe U.S. high yield ex-energy will outperform over the next year and are constructive on European high yield spreads given the weaker euro, lower fuel costs, and lower commodity exposure.

**Emerging Markets Debt (p. 11):** We are “selective,” continuing to find value in select hard currency bonds, particularly from commodity-importing countries and certain exporters.

**Municipal Bonds (p. 13):** Our positive view of the market is based on the relative cheapness of municipals combined with a supportive technical environment as we approach year end.

**Global Rates (p. 13):** We are opportunistic in this sector, seeing opportunities in U.S. TIPS. We hold less constructive views of JGBs and Canadian government debt.

**Mortgages (p. 14):** MBS look attractive to rates, but other high-quality spread sectors remain cheap on a relative value basis.

**Structured Product (p. 15):** We remain very positive on top-of-the-capital structure bonds and see the current market dislocation as an opportune time to increase allocations.

Spotlight on EMD—Learning from the Past

This quarter, David Bessey (left), Head of the Emerging Markets Debt Team, and Cathy Hepworth, EM Sovereign Strategist and Portfolio Manager, compare prior periods of Fed-induced volatility to the sector’s recent bout of turbulence.

See page 11 for the full recap.

Video Outlooks

Our Web site, PrudentialFixedIncome.com, also features video outlooks from our investment professionals. This quarter:

**Steven Kellner,** Head of Credit Portfolio Management, explains why the corporate sector should perform well for the remainder of the year.

**Robert Tipp,** Chief Investment Strategist, provides perspective on the current market environment in the context of anticipated Fed rate hikes.

**Terence Wheat,** Emerging Markets Corporate Portfolio Manager, gives some insight on the themes making headlines in the EM corporate market and areas of opportunity within the sector.

Additional Insights...

In “The Art and Science of CLO Analysis,” John Di Paolo, CFA, FSA, Principal, Structured Product Research Team, Brian Juliano, Principal, Leveraged Finance Team, and Edwin Wilches, CFA, Vice President, Leveraged Finance Team, explain the qualitative and quantitative characteristics needed to successfully navigate the nuances of the CLO sector.
Tales of Whoa!

Those expecting a volatile summer in 2015 got what they were looking for. The stresses that had been building ahead of the Fed's first potential rate hike since 2006 brought duress to a wide array of markets. Some of the "risk off" moves we witnessed were a continuation of existing trends—the rising U.S. dollar, widening credit spreads, falling commodity prices, and weakening emerging market stock and local bond markets—but new signs of trouble emerged as well.

First, in response to accelerating capital flight, the Chinese authorities allowed an uncharacteristically steep drop in the value of their currency in early-August (see the Quarter in Pictures). This aggravated the weak market environment as investors pondered the possible implications and knock-on effects should the Chinese economy and currency weaken further—would it lead to a global economic slowdown and an even more rapid depreciation of world currencies? At that point in mid-August, the market mood became so grim that even U.S. stocks, which had been in a fairly placid range for most of the year, dropped over 10%—the biggest drop in U.S. stock prices since 2011—and notably, it happened over the course of just a handful of days (see the Quarter in Pictures).

The fierceness of the move sent the VIX, a key benchmark of market anxiety, rocketing briefly above 50—the highest level of the past generation, barring the Great Financial Crisis. And while this summer swoon in risk appetite pushed spreads wider across the board, the pressure was particularly intense where idiosyncratic factors struck, which was the case in certain sectors, such as energy, and in certain countries, such as Brazil.

Fed Rate Hikes: No Laughing Matter

Fed tightening cycles, whether as short as one hike or a multi-year series, often end in calamity. In the most recent instance, the market stress began with taper, and it re-emerged in recent months as the fears of the Fed's so called “lift-off” began to boil.

Source: Bloomberg.
The August Chinese Currency Devaluation Broke the Back of the U.S. Stock Market—the Last Bastion of Quietude

Although Treasury Yields had Risen During the First Half of 2015 on Economic Optimism and Fears of Fed Rate Hikes, they Reversed Course in Q3

August’s Spike in Market Anxiety Lifted the VIX to its Highest Level in a Generation, Outside of the Great Financial Crisis

Spreads Continued to Widen in Q3

Source for charts in the Quarter in Pictures: Bloomberg and the CBOE for VIX data.
**What to Expect When Markets Expect Rate Hikes**

Uneasy conditions are a likely outcome of Fed action, since the trail of past Fed rate hike cycles is strewn with episodes of market dislocations, as observed in the preceding Fed chart. Fortunately though, the Fed is operating with its eyes open and realizes that hiking rates is not without risks. Hence, it opted to delay lift-off at the September meeting as falling stock prices and widening credit spreads were already effectively tightening financial conditions, and the Fed was reticent to exacerbate the situation. As the markets quieted after the Fed's September pass, Fed Chair Yellen signaled that rate hikes would be coming soon enough.

The markets simmered down towards quarter end, allowing the Aggregate index, a benchmark of the broad high-quality fixed income market, to post a return of more than 1% for the quarter and the year, but the returns of longer-term and lower-quality segments of the fixed income markets were hit to varying degrees by the risk-off sentiment, as indicated in the accompanying returns table.

**Weak Payroll Report Further Delays First Rate Hike**

In the first days of October, the U.S. employment report revealed that job growth had slowed significantly over the last two months of the quarter and that wage growth remained tame. Against a global backdrop of muted growth with pockets of extreme weakness, this sign that U.S. growth may be slowing is likely to both stay the Fed’s hand in October and significantly raise the bar even for a December hike.

**So Where Does that Leave Us?**

Net net, value was created in the bond market over the summer. Spreads have been pushed to very attractive levels relative to fundamentals and relative to the level of market yields. But investors remain uneasy about the weak global backdrop, the low level of rates, and the potential for the Fed’s impending lift-off to destabilize markets. Concerns like these are not just holding investors back. In some cases, they are creating a near vicious cycle where funding stress actually hurts fundamentals.

**Performance by Sector**

(Sorted by Q3 2015 Total Returns)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Return (%)</th>
</tr>
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<tbody>
<tr>
<td>U.S. Treasuries</td>
<td>1.76</td>
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<tr>
<td>Municipal Bonds</td>
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</tr>
<tr>
<td>Comm. Mortgage-Backed Securities</td>
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<tr>
<td>Mortgage-Backed (Agency)</td>
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<td>U.S. Aggregate</td>
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<td>European Leveraged Loans</td>
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<td>European IG Corporate Bonds</td>
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<td>Emerging Markets Debt Hard Currency</td>
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<td>U.S. High Yield Bonds</td>
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<tr>
<td>S&amp;P 500 Index</td>
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</tr>
<tr>
<td>Emerging Markets Local (unhedged)</td>
<td>-10.54</td>
</tr>
</tbody>
</table>

Sources: Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Senior Secured Loans (Credit Suisse), Euro Corp (iBoxx, unhedged). Performance is for representative indices as of September 30, 2015. See Notice for full index names. Past performance is not a guarantee or a reliable indicator of future results. An investment cannot be made directly in an index.

So, there is room for further market unraveling and ongoing volatility as we wait for the Fed. In the end, however, when the Fed’s rate hikes start, they will probably be limited to a very shallow path. While uncertainty may keep spreads wide over the near to intermediate term, over the long term, the net result could be substantial outperformance for the spreads sectors.

Furthermore, we continue to expect long-term Treasury yields to remain relatively low and range bound, which will continue to fuel the search for yield. And as this process plays out, we expect investor uncertainty and the resulting wide and frequent market fluctuations to continue to provide above-average opportunities for adding alpha through sector and issue selection as well as duration and currency management.

**The Bottom Line:** Short term uncertain; Longer-term outlook still favorable for fixed income—especially so for the higher-yielding sectors—with good opportunities for adding value through active management.
Global Growth Prospects Still Subdued and Subject to Material Risks

The global outlook remains overshadowed by a tightening in financial conditions amidst the eventual lift-off of Fed policy rates and idiosyncratic risks in the emerging economies (EEs). In the advanced economies (AEs), the prospective monetary policy tightening in the U.S. and the UK reflect the advanced stage of the economic cycle, while central banks in the euro zone and Japan are contemplating further policy easing.

Monetary policy normalization, however, would be taking place within the context of an all-time high of global leverage, as shown in the chart below. Foreign capital that previously funded rising leverage has been flowing out from the EEs and, when combined with falling commodity prices and rising yields, is posing major headwinds to growth. Nevertheless, sizeable stimulus is seemingly gaining traction and may yet buoy growth in China over the near term, although the medium-term prospects remain uncertain.

Overall Leverage* (% GDP)

Source: Bank for International Settlements and Prudential Fixed Income. *Defined as leverage across households, nonfinancial corporate and public sector; estimate is based upon 40 representative advanced and emerging economies.

U.S.—Eventual Fed Lift-Off

Few doubt that the U.S. expansion has matured to such an extent that, in isolation, it could not withstand an initial rate hike. Amidst solid performance of the labor market, despite an unexpected cooling in September, private domestic demand has been robust, as captured by the latest upward revision to second quarter GDP that was in large part spurred by private consumption.

Nevertheless, inflation indicators remain soft and well below target. The Fed, however, appears prepared to see through the disinflationary one-off effects from lower commodity prices and dollar strength. As Vice Chair Stanley Fischer pointed out in his Jackson Hole speech in August 2015, the Fed “...should not wait until inflation is back to 2% to begin tightening.”

However, amidst concerns that the faster-than-anticipated slowdown in China may spell another disinflationary episode, the Fed refrained from raising rates in September. Although these uncertainties over the global outlook have arguably not changed in a substantive manner, in her clearest hint yet that the Fed would raise rates, Chair Janet Yellen indicated soon after the September decision that most FOMC participants, including herself, anticipate an initial rate hike later this year.

Euro Area—Likely QE Expansion

Concerns about a potential disinflationary shock emanating from China put policy makers on guard at the European Central Bank (ECB). These concerns are unfolding against the backdrop of continued “lowflation.” While the fall in commodity prices has continued to depress headline inflation, core inflation has been hovering around 1%. In its latest quarterly update in September, the ECB materially revised down its forecast for 2016 headline inflation to 1.1% (from 1.5%), while only marginally lowering its 2017 forecast (1.7%).

Any signs of economic weakness—be it externally induced or domestic demand-driven—would most likely trigger a broadening of the ECB’s QE operations. It seems likely that a policy change may be announced at the December policy meeting, when the ECB will also revise its macroeconomic forecasts. In the meantime, the ECB is likely to continue to intervene verbally, in large part to stem euro appreciation and deliver on its 2% inflation target. In the words of Peter Praet, the ECB’s chief economist: “We have a mandate, and we’ll do whatever it takes.”

Japan—Abenomics 2.0

The Japanese economy continues to struggle and risks slipping into a technical recession in the third quarter. Furthermore, labor markets remain stretched—at 3.3% the unemployment rate has declined to a 20-year low—thus

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1 See http://www.federalreserve.gov/newsevents/speech/fischer20150829a.htm
2 See http://www.federalreserve.gov/newsevents/speech/yellen20150924a.htm
bolstering the outlook for wage and consumption growth. Meanwhile, core inflation (CPI excluding fresh food and energy) has edged up to 1.1% year-over-year in August, but, not unlike other countries, headline inflation remains lackluster (0.2% yoy). A major headwind for Japan’s growth and inflation outlook is the safe-haven status of the yen and its appreciation during the recent months of financial market volatility.

Continued economic weakness played a major role in S&P’s September decision to downgrade Japan’s sovereign rating (to A+ stable). Echoing concerns by the IMF over fiscal sustainability, the ratings agency suggested that adverse debt dynamics were unlikely to be stabilized over the medium term. In September, Prime Minister Abe unveiled “Abenomics 2.0.” The latest policy announcements, among other factors, aim to raise nominal GDP by 20% by 2020, mitigate the demographic decline, and step up social welfare, especially for the elderly. The concrete measures underpinning these targets remain to be announced, but the nominal growth target could well prove elusive given that potential growth is about 0.5%. Speculation is rife that Abe may have set the stage for the BoJ to follow on with some new form of stimulus, although the timing remains uncertain.

**Emerging Markets—Deleveraging Amidst a Terms of Trade Shock**

Emerging markets have been stung by tightening U.S. financial conditions, especially a soaring U.S. dollar that has exposed currency mismatches following a broad-based and persistent increase in leverage, as observed in the follow chart. In most countries, this increase has been predominantly in the private sector, with changes in public sector debt, especially external debt, relatively muted. The recent commodity price shock has compounded these strains for commodity exporters but, at the same time, has greatly alleviated strain for commodity importers. Amidst rising capital outflows, policy makers have so far opted to heavily rely on exchange rates as a primary shock absorber, a development that is overall supportive for sovereign credit fundamentals.

Global growth concerns have been exacerbated by the recent slowdown in China. As discussed in our Q3 Outlook, a substantial tightening in local government finances greatly aggravated this slowdown.

![Overall Leverage (% GDP)](chart)

Global growth concerns have been exacerbated by the recent slowdown in China. As discussed in our Q3 Outlook, a substantial tightening in local government finances greatly aggravated this slowdown. However, since then policy makers have embarked on a major course correction. The earlier fiscal tightening has been effectively unwound, while monetary policy flexibility is being regained by softening the FX peg and reversing some of the earlier measures to open the capital account. This should help policy makers to effect easier monetary conditions. Although this bodes well for a stabilization of growth, if not an acceleration over the near term, over the medium term, prospects for placing China on a sustainable growth trajectory remain uncertain. In particular, achieving sustainable growth will crucially depend on real sector structural reform, especially of the state-owned enterprise system, which has yet to reach critical mass.
U.S. and European Corporate Bonds

Concerns over slowing global growth and bouts of heavy new issuance held back the U.S. and European investment grade bond markets in Q3. U.S. corporates were also buffered by increasing event risk as they delivered a total return of 0.83% with an excess return to U.S. Treasuries of -146 bps. Corporate bond spreads over similar-maturity U.S. Treasuries rose 24 bps during the quarter to 169 bps. European corporate bond spreads also widened, closing 32 bps higher at 155 bps. European corporate bonds returned -0.34% and -1.88% for the quarter and year-to-date periods, respectively.

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<th></th>
<th>Total Return</th>
<th>Spread Change</th>
<th>OAS</th>
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<tbody>
<tr>
<td>U.S. Corporate</td>
<td>0.83%</td>
<td>-0.10%</td>
<td>24 bps</td>
</tr>
<tr>
<td>European</td>
<td>-0.34%</td>
<td>-1.88%</td>
<td>32 bps</td>
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</table>

Represents data for the Barclays U.S. Corporate Bond Index and IBoxx Euro Corporate Bond Index (unhedged). Sources: Barclays and IBoxx Markit, as of September 30, 2015. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

U.S. Corporate Bonds

Fundamentals in the U.S. corporate bond market remained favorable in Q3 (ex-energy and metals and mining) with many consumer-related sectors benefitting from a pick-up in U.S. economic growth. Market conditions were often challenging as investors tried to adjust to the effects of slowing global growth and lower commodity prices, uncertainty over the Federal Reserve’s lift-off, and increasing leverage from debt-financed acquisitions, dividend payments, and share buybacks. New issuance also posed a challenge, primarily in industrials, as year-to-date issuance was 20% higher than last year’s pace.

Financials were significant outperformers in Q3 as growing event risk and weakening energy and commodity prices weighed on the industrial sector and BBB-rated credits. So far this year, financials have returned +1.37% versus -80 bps for industrial bonds.

We hold a constructive view on corporates at current wider spread levels given solid U.S. growth prospects, the likelihood the yield curve will flatten once the Fed begins raising short-term rates, and the broader opportunity set across select industries and issuers resulting from the market volatility.

Investor demand for new issues remains strong with most new deals oversubscribed, while non-U.S. demand remains healthy given ongoing quantitative easing and the significantly lower yields in Europe and Japan.

As in prior quarters, we continue to favor U.S. financial issues including both senior and junior money center debt. Financial issuers continued to strengthen their balance sheets to meet capital and liquidity regulatory requirements and are relatively immune to event risk. Later in Q4, however, larger banks may experience added volatility when new, higher minimum capital buffer or “total loss absorbing capacity” (TLAC) requirements are expected to be announced, which may result in rating downgrades by Standard & Poor’s.

Within industrials, we favor autos, chemicals, and select retail and pharmaceutical issuers. We are emphasizing U.S. “centric” issuers over multi-national and export-driven companies whose earnings are vulnerable to a stronger U.S. dollar. We are focusing on select new industrial issues that are coming at concessions to outstanding secondary levels and where an “event” has passed. Although still cautious on the energy sector, we are searching for opportunities in light of the sector’s wider spread levels. We continue to favor BBB-rated bonds in shorter maturities, but are mindful of spread dislocations resulting from upcoming changes in money market regulations.

We also favor longer-maturities given the steep credit curve and strong demand potential from pensions and insurance companies should rates rise. We continue to favor taxable municipal revenue bonds that are not subject to growing government pension deficits and are generally a safe haven from event risk.

European Corporate Bonds

Sharply lower new issuance in the Euro corporate market during July and August kept spreads range bound in the face of increased volatility, which was primarily driven by global growth fears. In September, a rush of supply pressured secondary market spreads across both low and high-beta sectors. Euro corporate spreads rose 32 bps in Q3 with subordinate bonds the main underperformers. As in prior quarters, much of the supply was from “reverse yankee” companies issuing in the lower-yielding European markets.

Currently, we believe Euro corporate spreads appear attractive considering fairly robust fundamentals across many industries and the bottoming out of most European economies. However, spreads could rise further should the
pace of new issuance continue at record levels and liquidity conditions remain tight. Fallout from VW’s emission scandal, concerns over slowing growth in China, and elections in Greece and Spain, as well as lower liquidity, may also weigh on the market.

On a more positive note, the European Central Bank’s ongoing quantitative easing program should continue to provide support. Also encouraging is the ECB’s comments that it will do “whatever is needed” to spur growth, which could mean expanding the program, possibly in early 2016. Additionally, many industries and issuers should benefit from the “energy dividend” resulting from lower oil prices, although these benefits should run off in the coming quarters. European issuers remain a safe haven from event risk with M&A and shareholder-friendly initiatives well below U.S. levels.

Our strategy in Q3 remained relatively unchanged. We looked for opportunities to invest in issuers we believed were oversold, as well as in new issues with attractive concessions (20-30 bps at quarter end). We continued to focus on UK and Northern European issuers over peripheral country debt. We favor Euro industrials, including regulated companies with solid balance sheets, such as electrical grids and airport operators, over financial issuers. We find value in certain corporate hybrids from stable, well-rated utility issuers, and are avoiding hybrids issued to uplift ratings, including those in the telecom industry. In the banking sector, we prefer non-eurozone issuers and select senior bonds.

In global portfolios, we are implementing our favorite ideas from the U.S. and Europe: an overweight in U.S. issuers favoring financials and insurance companies over industrials, as well as select European issuers, favoring industrials and insurance over banks. We remain focused on BBB-rated shorter maturities and U.S. taxable municipals. We favor longer maturities in the U.S, where the spread curve is steep, but are more selective on longer-term euro issues, where spreads do not necessarily compensate for the risk. We continue to take advantage of yield discrepancies between U.S. and euro bonds of the same and/or similar issuers.

Although supply may periodically weigh on both markets, we believe spreads have room to tighten longer term, particularly in Europe where quantitative easing should support spreads. Key risks in Q4 include slowing global growth, heavy issuance (although there was less opportunistic issuance at quarter end due to increased market volatility), tighter liquidity, and, in the U.S., rising event risk.

OUTLOOK: Positive given wider spread levels, healthy fundamentals, and the potential for spreads to tighten again. Still favor U.S. financial issuers.

Global Leveraged Finance

High-yield spreads pushed wider in Q3 amid concerns about the Chinese economy, renewed declines in commodity prices, and retail outflows. While performance within the sector remains bifurcated between commodity and non-commodity credits, events in specific names contributed to a broader widening in U.S. spreads. The broader spread widening also shapes our outlook going forward as we believe the U.S. market is currently pricing in more pain than will likely come to fruition. Furthermore, even if it takes longer for spreads to compress to where we believe they should be, the spread carry alone is attractive. The European high yield market outperformed its U.S. counterpart given its lower level of commodity exposure. We hold a constructive view of European high yield given the prospect for limited new issuance and a potential increase in the ECB’s QE program.

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<th>Total Return</th>
<th>Spread Change</th>
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<tr>
<td></td>
<td>Q3</td>
<td>YTD</td>
<td>Q3</td>
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<tr>
<td>U.S. High Yield</td>
<td>-4.90%</td>
<td>-2.53%</td>
<td>+162 bps</td>
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<tr>
<td>European High Yield</td>
<td>-2.07%</td>
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<td>+103 bps</td>
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<tr>
<td>U.S. Leveraged Loans</td>
<td>-1.22%</td>
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<tr>
<td>European Leveraged Loans</td>
<td>0.0%</td>
<td>3.40%</td>
<td>+21 bps</td>
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Sources: BofA Merrill Lynch and Credit Suisse as of September 30, 2015. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index. European returns euro hedged.

U.S. High Yield and Leveraged Loans

Although spread widening in the U.S. was relatively broad based, there were distinct factors that drove the respective widening in the commodity and non-commodity sectors. The energy sector was a familiar laggard during the quarter as crude oil prices declined by 25% in Q3 to end the quarter at about $45 a barrel. The coal sector faces similar supply/demand challenges, and the two commodity sectors have been responsible for about two-thirds of the default volume thus far in 2015.
Despite the challenges for commodity credits, the U.S. default rate is expected to remain historically low at 3.4% over the next 12 months, according to Moody’s, with most defaults expected in the metals & mining sector. Looking further ahead, the default rate during the next cycle is likely to be lower than those in the past as borrowers have more flexibility due to looser covenants.

Within other, specific sectors, the drivers behind the spread widening were more idiosyncratic than macro related. Sprint Corp.’s downgrade by Moody’s during the quarter re-priced one of the more liquid names in the market as the wireless carrier struggles in a highly competitive marketplace. Frontier Communications Corp.’s $6.6 billion bond offering to finance an acquisition also pressured the telecom sector during the quarter. Other firms that needed to raise acquisition financing, such as Altice and Olin Corp., needed higher coupons and smaller sizes to clear the market, and in doing so, contributed to the repricing of their respective sectors. Elsewhere, the debt of aerospace firm Bombardier was pressured during the quarter as the company faces slow sales and high cash burn rates.

Given the market volatility in Q3, issuers that could delay entering the market did so, leading to a steep reduction in issuance, making August’s volume the lowest of the year. Issuers that delayed raising capital will likely return to the market when conditions stabilize. The market volatility was also reflected as the basis between cash bonds and CDX reached the widest levels in three and a half years.

In terms of positioning, our largest overweights were in the utility, technology, and capital goods sectors, and our largest underweights were in the energy and financial sectors.

While the -1.22% return for leveraged loans was the market’s worst quarterly performance since the third quarter of 2011, the asset class remains up 1.61% on the year, outperforming the bond market by more than 400 bps through the third quarter. The loan market has also remained relatively stable with the average price moving within a four point range, compared to nine points for the bond market. Even with that relative stability, only 6.5% of the loan market was trading above par at quarter end, which was the lowest level of the year, and it posted $10.9 billion in outflows compared to $6.7 billion in outflows from the U.S. high yield bond market.

Loan issuance was also muted in Q3 with 139 deals totaling $59 billion, $100 billion less than the new issuance volume recorded in Q2. Default activity remained low as well with the rate ending the quarter at 1.3%.

**European High Yield and Leveraged Loans**

While the spread widening in Europe occurred across the ratings spectrum in Q3, the greatest volatility was in specific credits, such as Abengoa. Fallen angel commodity names, particularly Petrobras, also contributed to the spread widening as they joined the high yield indices.

Looking ahead, we see spread tightening in the European market amid attractive new issue concessions, a subdued issuance pace, and signs that European economies appear to be steadying on lower energy prices and more competitive FX rates. Although there are negative points countering those aspects, such as challenging liquidity levels and concerns about slowing growth in China, our view towards the European high yield market is constructive overall. We continue to overweight risk within the asset class and believe single-B names offer attractive spreads. The European leveraged loan market has posted solid returns, particularly in comparison to the U.S. high yield market, amid healthy demand with limited supply and stable fundamentals. Looking ahead, although the loan market is generally lower quality than the European high yield market, spreads in the latter are higher, thus offering more spread for a higher-quality universe.

**OUTLOOK:** Positive. We believe U.S. high yield (ex-energy) should outperform over the next year on manageable new-issue supply, high exposure to U.S. consumers and investors’ reach for yield. Spread carry is attractive in the current range. U.S. leveraged loan technicals are challenging given retail outflows and reduced CLO formation. We are constructive on European high yield amid the weaker euro, lower fuel costs, and less commodity exposure.

**Emerging Markets Debt**

Emerging market debt returns were mixed in Q3, with hard currency sovereign returns modestly lower, followed by solid declines in EM corporate and steeper drops in local currency debt (unhedged) and EMFX.
Outperformers in hard currency were predominantly lower-quality, idiosyncratic countries, such as Argentina (+7.28%), Belarus (+6.19%), and Ukraine (+50.18%), with the latter announcing an investor-friendly restructuring during the quarter. Underperformers included oil and commodity exporting countries, such as Ecuador (-18.67%), Gabon (-13.25%), Iraq (-13.28%), and Zambia (-18.14%). Brazil (-9.97%) also underperformed on a continuation of the Lava Jato scandal coupled with downgrades by Moody’s (to Baa3) and S&P (to BB+). Eastern Europe was the best performing region due to its low commodity sensitivity and strong ties to the west, while Latin America and Africa underperformed.

Local market returns were driven by poor performance in EM currencies, with the ELMI+ currency index returning -6.35% for the quarter. The third quarter saw a resurgence of the strong USD environment, with concerns about a Fed rate hike, weakening EM growth, China’s economic outlook, and weakening global trade all weighing on the EM currency markets. As was the case with hard currency bonds, the currencies of commodity exporters were particularly hard hit, with Colombia (-15.14%), Malaysia (-13.18%), and South Africa (-10.74%) finishing the quarter as major underperformers, along with scandal plagued Brazil (-19.42%).

EM corporate returns were dragged down by exposure to Brazil (-16.86%), where many of the corporates were hit by the commodities selloff and the Lava Jato scandal. Other underperforming countries included Colombia (-11.03%), Mongolia (-35.61%), and Nigeria (-11.38%).

### A Look at Past Crises

Given the negative headlines regarding the emerging markets’ outlook, some investors are wondering whether we are heading into a prolonged period of EM turbulence. For some perspective on the matter, a comparison with prior crises could be instructive.

#### Scenario I — 1980’s Latin America

The Latin American crisis in the early 1980’s was associated with weak commodity prices and slowing global growth—similar to the characteristics of today’s environment. Back then, however, most of the borrowing was LIBOR-based, leaving many countries highly exposed when the Fed raised rates and LIBOR spiked. Today, sovereigns have less LIBOR sensitivity after having spent the last decade extending their maturity profiles. The average life of bonds in Brazil, Mexico, Indonesia, Turkey, and many other EM countries is over 10 years, and virtually all of the debt is fixed rate. Additionally, EM currencies were spectacularly overvalued going into the early 1980s; the Mexican peso real effective exchange rate appreciated 31% from 1977 to 1981. Currently, many EM currencies are trading at levels which are substantially cheaper than their 5-year and 10-year averages.

#### Scenario II — Late 1990’s in Mexico, Asia, and Russia

The Mexican, Asian, and Russian crises in the mid to late 1990s were classic “balance of payment” crises associated with fixed exchange rates. Countries with currency pegs were forced to maintain high real local interest rates to resist currency depreciation pressures, and these high interest rates resulted in a flood of short-term inflows. As investors became concerned that the currency pegs might break, the short-term money flowed back out, and central banks were forced to spend down reserves to maintain the exchange rates. Eventually, the pegs had to be abandoned, putting pressure on banking systems and forcing a sharp reduction in credit creation and severe funding difficulties for sovereigns and local corporates. What is different today? Most importantly, most EM currencies are now floating rather than fixed. While EM currencies have depreciated sharply, this depreciation has been an important safety valve for EM economies. Most EM central banks have made only marginal reductions in foreign currency reserves, and overall reserve levels are broadly higher than they were five years ago. The selloff in EM currencies has made them relatively inexpensive, with many currencies back to levels not seen since the early 2000s. This should sow the seeds for an eventual recovery in exports and foreign investment.

### Looking Ahead…

Moving to the current situation, what about overall debt levels? Since 2007, emerging market sovereigns have actually lowered the amount of foreign currency debt that they
owe as a percent of GDP. The average foreign currency debt/GDP ratio for the so-called “Fragile Five” (Indonesia, Turkey, Brazil, South Africa, and India) is 9.9%, down from 12.6% in 2007. To be fair, gross government debt (both local and foreign currency) is higher, but it still averages 46.5%, a level far below what is seen in the developed world. Corporate debt has risen in many countries since 2009 and needs to be monitored, but we believe it is unlikely that EM corporates could cause systemic sovereign crises in most countries.

None of this is meant to diminish the difficulties currently facing many EM countries, and we expect more downgrades than upgrades over the upcoming quarters. Commodity prices have halved in many cases, leading to predictable negative impacts on commodity producers. China’s growth is slowing, putting downward pressure on imports from many trading partners across Asia and beyond. Global trade is anemic, making it difficult for countries to export and improve their current accounts. However, we believe that these difficulties are manageable for most countries given the state of sovereign balance sheets and currency structures, and we think that there is a low likelihood of a major EM crisis of confidence. Careful country-by-country analysis should provide opportunities to take advantage of mispriced securities within the sector. Importantly, in the context of the current low interest-rate environment, we believe that hard currency bonds in particular offer attractive prospective returns.

OUTLOOK: Selective. We see value in select hard currency bonds, particularly from commodity importing countries and select exporters, such as Argentina, Russia, and Kazakhstan. We prefer sovereigns to corporates, although certain corporates are attractive. We maintain long duration in local bonds, the yields of which are near decade highs. We have reduced shorts in EMFX due to improved valuations after the most recent selloff.

Municipal Bonds

AAA-rated municipal bonds underperformed U.S. Treasuries across most of the yield curve but kept pace on the long end with the 30-year Municipal/Treasury yield ratio unchanged at 106% at quarter end. Lower yields led to positive total returns in Q3 for high grade and high yield municipals, 1.65% and 1.99%, respectively. Year-to-date (YTD) returns are 1.77% and 0.03% for high grade and high yield, respectively. High yield returns continue to be influenced by Puerto Rico credits which returned 0.29% in Q3 and -10.73% YTD. Long taxable municipals returned 1.72% in Q3 and -1.61% YTD.

The pace of issuance continued to slow in Q3, but was still 8.5% higher than 2014 and YTD total supply of $309 billion represents a 32% increase vs. the prior year, with refunding volume comprising over 50% of the total. Despite lower yields by quarter end, volatility throughout Q3 likely weighed on mutual fund flows. Net outflows for Q3 exceeded $3 billion; however, YTD net flows remain positive at $5 billion.

The volatility in Puerto Rico continued in Q3 as investors digested the news flow from the island, including the first default by a Puerto Rico issuer, a 5-year fiscal and economic recovery plan with few details, a preliminary restructuring agreement between the Puerto Rico Electric Power Authority (PREPA) and a group of creditors, along with another extension of the forbearance agreement between PREPA and certain creditors. Bond prices generally bounced off the lows experienced at the end of Q2, resulting in improved quarterly returns. However, we expect volatility to continue in Q4 as investors await the Administration’s debt restructuring proposal. While a recent report from the Commonwealth noted that any restructuring will “reflect, and seek to respect Constitutional priorities” for GO debt repayment, a formal proposal has yet to be released by the start of Q4. Reportedly, officials and their advisers had an initial meeting with certain Government Development Bank (GDB) bondholders regarding a debt negotiation.

Credit pressures remain for states and other entities with pension issues. The State of Illinois continues to operate without a budget for fiscal year 2016, which began on July 1. The Republican Governor and Democrat-controlled legislature remain at odds over how to address structural imbalances in the budget and the significant underfunding of state pension plans. While Chicago also struggles with structural budget imbalances and underfunded pensions, the Mayor appears to have the political will to begin addressing some of these long standing issues with his proposed property tax increase.

Increased supply early in Q4 could pressure tax-exempts near term. However, a stable-to-lower rate environment may contribute to positive mutual fund flows. In addition, the relative attractiveness of tax-exempts should be supportive of institutional demand. These factors, combined with a strong technical environment toward year end, could lead to outperformance in Q4. The credit stories that have weighed on the municipal market throughout 2015 will continue in Q4 as news related to Puerto Rico, Illinois, and Chicago will keep

Sources of data on this page: Emerging markets debt, J.P. Morgan. Municipal bond supply, J.P. Morgan; Municipal returns, Barclays.
these credits in the headlines. Despite the headlines, we maintain that these credit stories do not pose a systemic risk to the broader municipal market. We continue to believe that unfunded pension liabilities remain the biggest credit risk for certain states and localities. We expect taxable municipalities to perform in line with U.S. corporate bonds with the potential to outperform if supply continues to pressure corporate bond spreads.

OUTLOOK: Positive based on relative cheapness of munis combined with a supportive technical environment as we approach year-end.

Global Rates

The third quarter was dominated by concerns of weakening global growth, turbulent international equity markets, and anticipation of potential Federal Reserve action. The increased volatility led to a sustained rally in long-term interest rates across global developed markets.

Australian 10-year yields led the global bond rally, falling 40 bps in Q3 given concerns over China’s slowing economy, while yields in the UK and Germany declined more than 20 bps. Despite the potential for the first Fed interest-rate increase in almost a decade, U.S. 10-year Treasury yields declined 30 bps and finished the quarter just over 2.00%.

Given the weakening backdrop and the accompanying volatility, one might have assumed the safe-haven bid for U.S. Treasuries would have pushed the 10-year yield materially lower than 2.00%. However, the strong linkage between emerging market currency weakness and capital outflows led reserve managers to sell existing U.S. Treasury positions, which restrained the U.S. bond richening. The effect of this selling was most evident in the cheapening of Treasuries versus fixed-rate LIBOR swaps, and swap spreads consequently tightened to the lowest levels on record.

Further compression of U.S. swap spreads was caused by a large amount of fixed-rate corporate bond issuance that was hedged to floating. This is exclusively a U.S. phenomenon, as other developed market swap spreads were stable to wider in Q3. We maintain a constructive view on swap spread wideners over the coming quarter as the aforementioned effects abate.

Weakening global demand also continued to pressure commodity prices, which led to another steep decline in U.S. inflation expectations. Five-year implied inflation breakeven approached 1.05% as Q3 concluded, representing a post-financial crisis low. As a result, U.S. TIPS offer very good value on a relative basis and could outperform nominal Treasuries going forward.

Looking ahead, we believe global macro conditions continue to be supportive of positive absolute returns in U.S. Treasuries and German bunds. While we view U.S. Treasury yields as largely range bound, the lack of economic acceleration at this point of the cycle could give the Fed pause in raising rates and likely lead to further positive performance in U.S. Treasuries. In Europe, the continuation and potential expansion of ECB QE should remain supportive for German bunds.

We remain less constructive on JGBs and Canadian government bonds. With yields in Japan offering little compensation over cash rates out to the 7-year maturity, JGBs may underperform in the coming quarter. Similarly, the Canadian yield curve may steepen slightly and underperform other global markets.

OUTLOOK: Opportunistic. We see opportunities in U.S TIPS and breakeven rates as well as a gradual decline in 10-year bund yields. We hold less constructive views of JGBs and Canadian government debt.

Mortgages

Agency mortgage-backed securities delivered a total return of 1.30% in Q3 with an excess return to U.S. Treasuries of -22 bps. Year-to-date, the agency MBS sector has posted a return of 1.61%. MBS experienced increased spread volatility in Q3 given the uncertainty surrounding the Federal Reserve’s rate hike, as well as broader, macro risk-off themes.

During the period, the MBS sector benefitted from declining prepayment speeds as primary mortgage rates remained in a fairly narrow range. MBS origination did rise in response to seasonal home purchase activity but was fairly contained given the level of mortgage rates. The Fed’s MBS reinvestment program continued, helping to absorb supply, although the size of the monthly reinvestment declined as aggregate prepayment speeds fell. In recent comments, Fed officials and Federal Open Market Committee minutes suggest that definitive plans have not been made regarding future MBS reinvestment, which we believe will continue well into 2016.

Sources of data on this page: Global Rates, Bloomberg.
GNMAs, the worst performing sector so far this year, improved from the sharp price declines experienced when President Obama announced a mortgage insurance premium (MIP) cut in January. Prepayments resulting from the MIP cut have since fallen, which encouraged some investors to add back exposure.

We believe current MBS spreads are attractive relative to U.S. Treasuries. We look for prepayments to remain muted unless interest rates rally sharply or government policy risk resurfaces. We expect the Fed’s reinvestment program to remain in place until well after the first interest rate hike. Overall, MBS performance in Q4 will be impacted by the market’s expectation of the Fed’s initial rate hike, as well as broader macro risk themes.

In this environment, we continue to favor specified pools over TBAs as we expect front-end funding pressures to negatively impact the TBA dollar roll market. We continue to favor 30-year mortgages, which offer higher liquidity and more attractive valuations than intermediate mortgages. Lastly, we will continue to selectively cover GNMA exposure as opportunities arise.

**OUTLOOK:** MBS look attractive to rates, but other high-quality spread sectors remain cheaper on a relative value basis.

### Structured Product

The third quarter was true to form as spreads widened in the structured product markets, primarily due to market volatility and in sympathy with other spread product (e.g., corporates); Fundamentals remain strong and the spread widening was generally less than in other sectors. The fourth quarter has historically been positive for spreads on structured products and one has to look back to 2010 and 2012 to find spreads this wide in ABS and CMBS, respectively. We therefore believe that current spreads offer a solid opportunity to increase allocations to structured product, and we continue to find the most value in top-of-the capital structure bonds.

**CMBS** – Top-of-the-capital structure commercial mortgage-backed securities (CMBS) remain fundamentally attractive despite underperforming Treasuries in the third quarter. New issue 10-year, super-senior conduit bonds widened roughly 20 bps during the quarter to around Swaps (S)+120. Bottom-of-the-capital structure CMBS performed worse, with BBB-widening 125 bps. Agency CMBS also performed poorly in the third quarter, with spreads widening 20 bps to S+70a.

AAA-rated Single Asset/Single Borrower (SASB) floater spreads were stable throughout the quarter at LIBOR (L) +115 -125 bps. We still see pockets of value in SASB securitizations, including some senior mezzanine tranches, but collateral considerations are paramount as the sector is not homogeneous. While senior CMBS spreads are vulnerable to broad-based market de-risking, CMBS fundamentals remain solid. Commercial real estate values are now 13% past their 2007 peak, but both cap rates and prices appear sustainable at current levels. For new issue CMBS, we see some softening of loan underwriting standards (more interest only loans, secondary property markets, etc), but debt-service coverage ratios on newly originated loans remain higher than they were pre-crisis and the use of pro forma underwriting is still limited. We therefore do not expect to see broad-based credit problems in newly issued CMBS, particularly in super-senior bonds. With respect to legacy CMBS fundamentals, delinquencies in ’06/’07 CMBS pools remain high, but continue to decline, albeit at a slower pace. We believe losses on pre-crisis legacy deals will be limited to subordinate classes, such as class AJ and below. The conduit new issue CMBS market issued $60 billion in 2014, and we maintain our projection for 2015 at $65 billion, which is now about 15% lower than most projections in the beginning of the year. Fannie Mae and Freddie Mac originated $50 billion backed by multi-family properties in 2014 and are on pace to issue $60 billion in 2015. The market continues to absorb new issue supply, which was about $17 billion in Q3, but new issue concessions have increased to 3-5 bps. While net issuance in the CMBS sector is close to zero with maturities of legacy bonds offsetting new issuance, the net duration add represents a formidable technical headwind that the market will have to contend with as it refines the wall of maturities from 2016 to 2017.

**ABS** – ABS spreads were wider in the third quarter alongside broad market softness, interest rate uncertainty, and diminished dealer liquidity. Front-end benchmark ABS again underperformed in sympathy with corporates as 2(a)7 money market reform and bank regulation pressured the front-end of the maturity spread curve. Spreads on benchmark credit cards and auto ABS were 5-10 bps wider (e.g. 3-year AAA cards are L+40 and 1-year AAA top-tier prime autos are L+35). Notably, the student loan FFELP ABS market came under pressure this past quarter as Moody’s and Fitch placed a large number of bonds on downgrade watch due to concerns that collateral prepayment speeds have slowed to the point that bonds may not be repaid by their legal final maturities. Prepayment speeds have slowed due to government sponsored programs to alleviate student loan debt payments. Despite slow prepayment speeds, the

Sources of data on this page: Mortgages, Barclays.
underlying loans are still 97% guaranteed by the U.S. and, with securitization credit enhancement, extremely unlikely to suffer any loss of principal. Spreads on these bonds have widened 50-100 bps based on tenor. That said, we do not believe this is a good entry point for FFELP or Private Student Loans. Spreads could widen further in response to forced selling due to prospective downgrades and a repricing of risk premia in response to the slower- than-expected prepayment speeds. Away from student loans, non-benchmark ABS spreads were wider by 10 bps on average (e.g. 5-year senior rental car ABS to L+ 100 and senior 3-year sub-prime consumer loan ABS to L+170). New issue ABS supply was $145 billion as of the end of Q3, slightly ahead of last year’s pace. We are neutral on benchmark sectors, such as credit cards and autos, with relatively low carry and limited long-term upside, and we are looking to add select, fundamentally strong, non-benchmark sectors and issuers with more favorable economics.

**Non-Agency Residential Mortgages** – Government Sponsored Enterprise (GSE) credit risk transfer deals had a difficult quarter, in line with other risk assets. For example, Fannie Mae’s CAS M1s widened 35 bps and the longer M2 bonds 100 bps; this despite exemplary credit performance in all deals issued thus far. Senior pre-crisis legacy bond prices outperformed CRTs but still softened by ½-1 points in Q3. Technical factors remain positive as annual paydowns are approximately 15% of outstanding issues and new issue supply is minimal. Fundamentals also continue to improve – the percent of loans making payments has been steadily increasing for over four years, HPA continues to increase (expected to be 4% to 5% in 2015 and 2-4% in 2016), and job growth remains solid. We continue to find value in the senior tranche of re-remics of senior ’06/’07 bonds. The added enhancement provided by the junior re-remic tranche significantly improves the credit profile, yet senior re-REMIC tranches trade very attractively in the LIBOR + 230-330 bps range. We also find value in the senior tranche of non-performing loan securitizations – these trade at about 4% yield for front-end cashflows and have about 50% enhancement to underlying property value. We continue to favor ’05 and prior sub-prime bonds with significant enhancement, which trade in the L+175-225 bps range. It remains our view that many non-agency mortgage investors do not hedge duration and could be hurt if interest rates selloff further. Outside the U.S., UK non-conforming mortgages have widened significantly as the re-positioning from legacy holders accelerates. Spreads on 5 year AAA paper have widened about 100 bps this year, with about 75 bps coming this quarter to L+175. While we find this level attractive, we are closely watching large asset divestitures – notably the UK government resolution of their Northern Rock holdings – and the effect on spreads.

**CLOs:** AAA-rated U.S. collateralized loan obligation (CLO) primary market spreads widened by 10 bps to 3L+150 bps. This brings year-to-date spreads close to unchanged. Spreads widened due to market volatility and headwinds from regulatory developments. That said, spread widening was contained, in large part, due to continued strong demand from banks, asset managers, and insurance companies. Secondary short weighted average life CLOs were wider by 30 bps at L+140 bps. These bonds moved wider because of slower pre-pay speeds and regulatory driven balance sheet concerns for banks—for example, many pre-crisis bonds are not Volcker compliant. In Europe, spreads on AAA-rated CLO primary deals were 5 bps wider at 3L+135 bps. Unlike the U.S., European supply remains constrained given the implementation challenges of risk retention and the limited CLO investor base. We continue to believe CLOs offer solid relative value in both the primary and secondary markets. In the primary U.S. market, investors in AAA tranches continue to enjoy a favorable environment to negotiate spreads and covenants. In the long run, we strongly believe CLO spreads will compress; in the short and medium term, spreads will remain a function of supply and regulation, which will provide a positive environment to continue to opportunistically add to positions in a fundamentally attractive asset class.

**OUTLOOK:** We remain very positive on top-of-the-capital structure bonds and we see the current market dislocation as an opportune time to increase allocations. We are selectively positive on senior mezzanine cashflows, and of note, we are negative on lower-rated new issue CMBS as loan underwriting quality has softened.
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- U.S. Investment Grade Corporate Bonds: Barclays U.S. Corporate Bond Index
- European Investment Grade Corporate Bonds: iBoxx Euro Corporate Index 100% (unhedged)
- U.S. High Yield Bonds: BofA Merrill Lynch U.S. High Yield Index
- European High Yield Bonds: Merrill Lynch European Currency High Yield ex Finance 2% Constrained Index
- U.S. Senior Secured Loans: Credit Suisse Leveraged Loan Index
- European Senior Secured Loans: Credit Suisse Western European Leveraged Loan Index: All Denominations Unhedged
- Emerging Markets Local Debt (unhedged): JPMorgan Government Bond Index-Emerging Markets Global Diversified Index
- Emerging Markets Corporate Bonds: JP Morgan Corporate Emerging Markets Bond Index Broad Diversified
- Emerging Markets Currencies: JP Morgan Emerging Local Markets Index Plus
- Municipal Bonds: Barclays Municipal Bond Indices
- U.S. Treasury Bonds: Barclays U.S. U.S. Treasury Bond Index
- Mortgage Backed Securities: Barclays U.S. MBS - Agency Fixed Rate Index
- Commercial Mortgage-Backed Securities: Barclays CMBS: ERISA Eligible Index
- U.S. Aggregate Bond Index: Barclays U.S. Aggregate Bond Index