PGIM

# Q3 25 FIXED INCOME QUARTERLY OUTLOOK

Published July 2025

# WHATS INSIDE?

Select a section to jump ahead.



| | Total Returns (%) | | | | |
|---|---|---|---|---|---|
| **Individual FI Sectors** | Q2 '25 | YTD | 2024 | 2023 | 2022 |
| EM Currencies | 7.09 | 10.44 | -1.08 | 8.44 | -7.14 |
| U.S. High Yield Bonds | 3.53 | 4.57 | 8.19 | 13.45 | -11.19 |
| EM Hard Currency Sovs. | 3.32 | 5.36 | 6.53 | 11.09 | -17.78 |
| EM Local (Hedged) | 2.75 | 4.41 | 3.77 | 7.60 | -8.85 |
| U.S. Leveraged Loans | 2.33 | 2.96 | 9.05 | 13.04 | -1.06 |
| CMBS | 1.88 | 4.49 | 4.68 | 5.42 | -10.91 |
| U.S. IG Corporate Bonds | 1.82 | 4.17 | 2.13 | 8.52 | -15.76 |
| European IG Corporate | 1.81 | 1.80 | 4.74 | 8.19 | -13.65 |
| European High Yield Bonds | 1.74 | 2.30 | 9.14 | 12.78 | -11.13 |
| European Leveraged Loans | 1.38 | 2.38 | 9.17 | 13.53 | -3.36 |
| U.S. Long IG Corporates | 1.23 | 3.64 | -1.95 | 10.93 | -25.62 |
| Mortgage-Backed (Agency) | 1.14 | 4.23 | 1.20 | 5.05 | -11.81 |
| U.S. Treasuries | 0.85 | 3.79 | 0.58 | 4.05 | -12.46 |
| Municipal Bonds | -0.12 | -0.35 | 1.05 | 6.40 | -8.53 |
| Long U.S. Treasuries | -1.53 | 3.08 | -6.41 | 3.06 | -29.26 |
| **Multi-Sector** | | | | | |
| Global Agg. (Unhedged) | 4.52 | 7.27 | -1.69 | 5.72 | -16.25 |
| Euro Aggregate (Unhedged) | 1.75 | 0.84 | 2.63 | 7.19 | -17.18 |
| Global Agg. Hedged | 1.61 | 2.81 | 3.40 | 7.15 | -11.22 |
| U.S. Aggregate | 1.21 | 4.02 | 1.25 | 5.53 | -13.01 |
| Yen Aggregate | -0.21 | -2.59 | -3.07 | 0.51 | -5.30 |
| **Other Sectors** | | | | | |
| S&P 500 Index | 10.94 | 6.20 | 25.00 | 26.29 | -18.11 |
| SOFR | 1.10 | 2.20 | 5.40 | 5.18 | 1.66 |
| U.S. Dollar (DXY Index) | -7.04 | -10.70 | 7.10 | -2.11 | 8.21 |

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 (S&P UBS). European returns are unhedged in euros unless indicated. Performance is for representative indices as of June 30, 2025. An investment cannot be made directly in an index.

SECTION 1

# KEY CONVICTIONS & INVESTMENT THEMES

01

## KEY CONVICTIONS & INVESTMENT THEMES

1 **Strategic Buy Zone for Bonds:** The 2022 bear market lifted yields to levels not seen for more than a decade, positioning fixed income markets—particularly the higher-yielding sectors—for solid, long-term returns. That backdrop remains, as do the uncertainties that will likely rattle markets over the near term. **Bottom line: Bonds are positioned for solid returns, and they should outperform cash and equities if serious downside risks materialize.**

2 **Bond Bull Market of Distinction:** With the markets finely balanced between conflicting forces of monetary and fiscal policies, geopolitical tensions, and tariffs, performance dispersion across yield curves and credit sectors has ranged widely from positive to negative returns. **The dispersion indicates that just buying bonds won't do; success will hinge more than ever on buying the *right* bonds in the *right* maturities and market sectors.**

3 **Let Fundamentals be your Guide—Look Through the Noise to Find the Signal:** As participants struggle to chart their course amidst the cascade of headlines, markets have been prone to dramatic overreactions and course corrections. **The lesson for investors is clear: don't confuse extreme market movements with changes in fundamentals.** Rely on research and analysis to distinguish the market spasms from true changes in underlying value and capitalize on reversions back to fundamentals.

SECTION 2

# BOND MARKET OUTLOOK

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

02

# THE BULL MARKET CLIMBS A WALL OF WORRYING HEADLINES

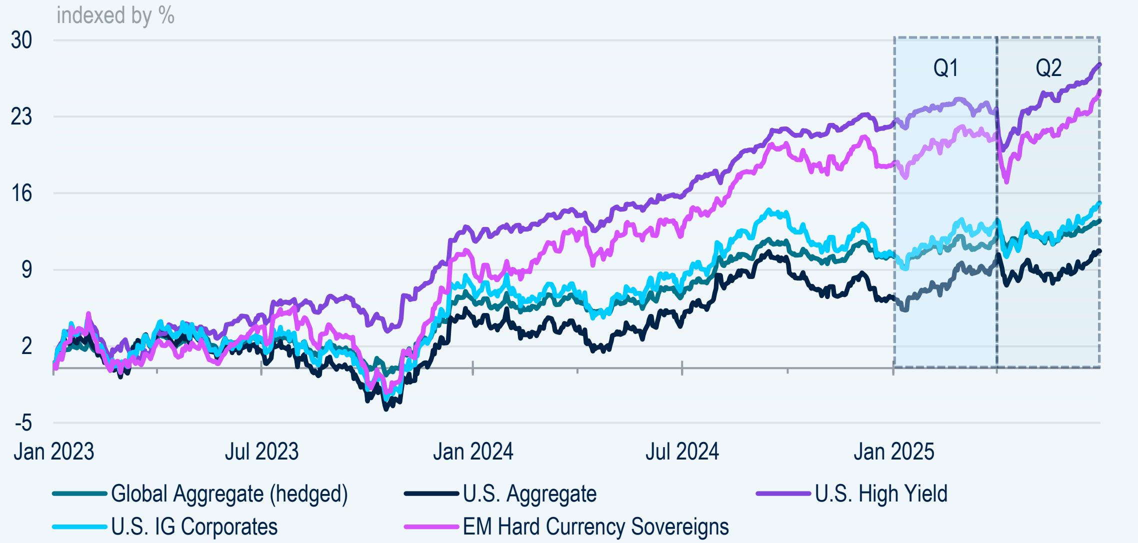
**The unusual bull market that started towards the end of 2022 continued through the second quarter of 2025. In contrast to a typical bull market where the dominant driver of returns consists of a wholesale drop in yields, this bull market continues to be mostly fueled by the simple accrual of yield itself as well as the incremental return on spread products (Figure 1). Credit products have not only posted the best performance this year, but they have also turned in the best performance over the duration of the bull market. The riskier sectors, such as high yield and emerging market hard currency, have posted the highest returns.**

**Maturity has been another critical—if not counter-intuitive—factor during this bull market as longer maturities have underperformed.** Since rates reached their approximate levels in late 2022, the ends of yield curves have, at times, actually gone in opposite directions, wreaking havoc with the absolute returns—not to mention the risk-adjusted variety—on longer bonds in Western markets (Figures 2, 3a, and 3b).

### What's Next? A Continued Bull Market of Distinction

Looking ahead, geopolitical risks and trade tensions will likely remain high. However,

**Figure 1:** The higher-risk sectors, such as high yield and emerging market hard currency, have continued to post the best returns followed by the investment grade corporate, global aggregate (USD hedged), and U.S. aggregate indices.[1]




Source: Bloomberg

[1] Global hedged indices have typically delivered similar performance to domestic single currency indices, but with much less volatility owing to the benefits of global diversification.

**Figure 2:** Over the past year, short and long yields have gone in opposite directions in the U.S. and in Europe.


Source: Bloomberg

moderate growth and moderating inflation in major developed markets (DMs) look set to continue, with Western central banks generally expected to hold or cut rates in the quarters ahead (see the following economics section). **In turn, this is likely to keep overall rate levels stable to lower, albeit with the potential for further yield curve steepening** (see DM rates section). On net, this backdrop of stable to falling rates should support the bond market overall.

Regarding credit, while growth prospects may not be strong enough to warm the hearts of equity investors, fundamentals generally remain firm despite the worrying economic and geopolitical headlines (discussed in the individual credit sections that follow).

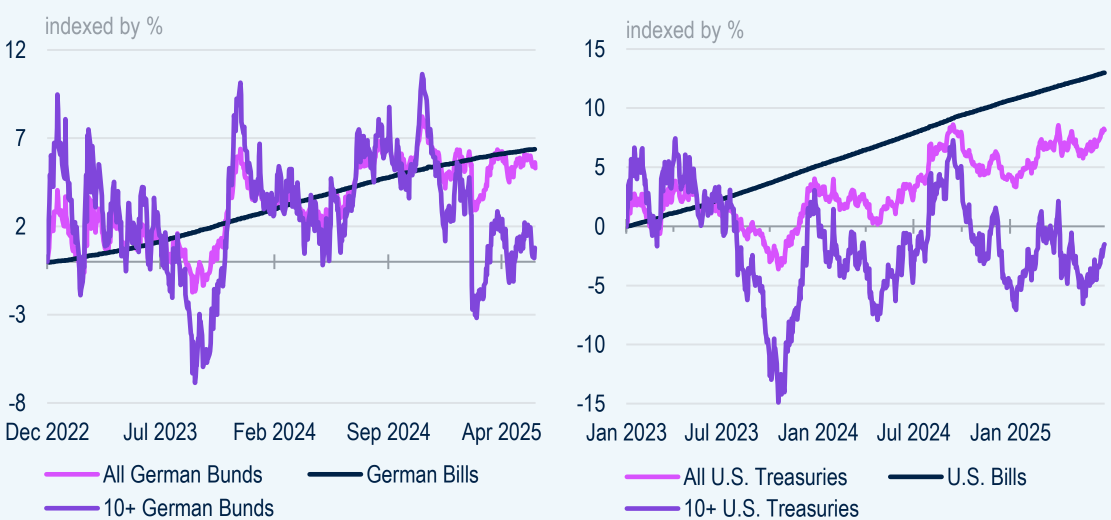
**Ironically, the ongoing backdrop of seemingly nonstop policy headlines fueling uncertainty is perhaps a positive for credit investors. It prevents exuberance among debtors that, in clearly buoyant times, invariably leads to a steep rise in downside credit risks.**

Despite this surprisingly benign economic outlook, as has been the case this year, we expect to see intermittent bouts of volatility in credit spreads as events unfold. Nonetheless, the underlying durability of fundamentals, along with the favorable supply/demand balance in credit markets, **generally suggest that spreads may remain towards the bottom end of their historical ranges in the quarters ahead (Figure 4).**

This should support further, albeit more modest, outperformance by credit products.

**Bottom line: Despite headline-driven bouts of volatility, stable-to-lower yield curves with range bound credit spreads should allow the bond bull market to continue. Selectivity will be key, with the higher yielding credit sectors likely delivering the highest returns.**

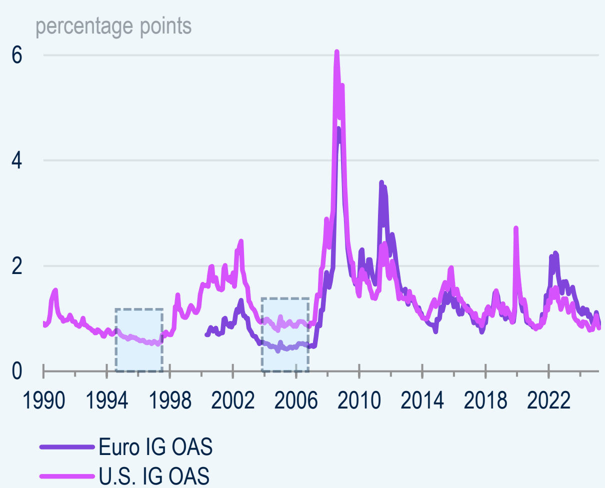
**Figure 3a and 3b:** Contrary to the typical bull market, absolute and risk-adjusted returns on government bonds have actually been inversely correlated with duration. German and U.S. T-bills have produced the highest absolute and risk-adjusted returns, while the 10+ year market segments have delivered negative returns with high volatility.




Source: Bloomberg

Source: Bloomberg

**Figure 4:** Bouts of volatility notwithstanding, firm fundamental and technical underpinnings may allow credit spreads to remain towards the narrow end of their historical ranges.




Source: Bloomberg

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WEBCAST

### Q3 2025 FIXED INCOME OUTLOOK

PGIM's Q3 2025 Fixed Income Outlook will cover the latest, global economic developments pertaining to trade and geopolitics as well as our expectations across the global bond markets.

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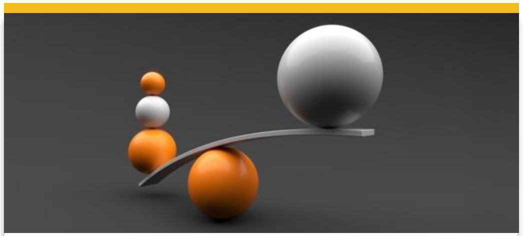

BLOG POST

### THE CASE FOR HIGH YIELD VS. EQUITIES

In an environment where risk assets are increasingly beholden to macro developments, this post assesses the relative value of global high yield bonds vs. global equities.

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BLOG POST

### CLO ETFS AND THE TARIFF-INDUCED STRESS TEST

In this episode, we examine April's tariff-driven volatility served as the first meaningful stress test for the collateralized loan obligation (CLO) ETF market.

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SECTION 3

# GLOBAL MACROECONOMIC OUTLOOK

By Katharine Neiss, PhD, Deputy Head of Global Economics and Chief European Economist

03

# OPPORTUNITIES WITH U.S. EXCEPTIONALISM IN QUESTION

**As the U.S. economy continues easing, other major economic regions remain remarkably resilient. Tariff uncertainty has rattled business sentiment and dented investment plans, but consumption is stabilising amidst the real-income recovery from the post-COVID cost-of-living shock. Our base case is for major economies to "muddle through" the wide-ranging shocks to the global economy, be they tariffs or additional geopolitical surprises. Longer term, it's a scenario that is consistent with the emergence of a multi-polar world, along with its attendant investment implications.**

Alongside the U.S. economic easing, questions around fiscal sustainability, the credibility and independence of U.S. institutions, and the rule of law create opportunities elsewhere. Given its comparable economic size, level of development, and established institutions, Europe offers an alternative. That said, key gaps around the region's depth of capital markets remain a barrier that will require significant political will, as well as time, to meaningfully narrow.

## U.S. and Euro Area—Converging Growth Paths

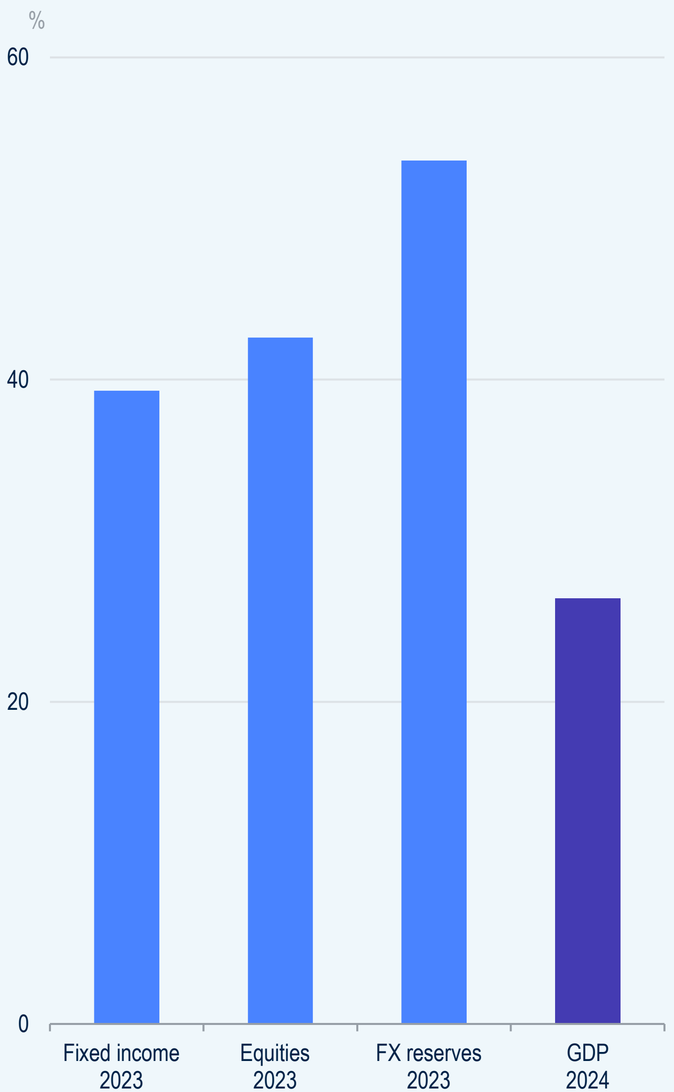
At 2.8%, U.S. real GDP growth in 2024 was more than three times faster than growth in the euro area. This underpinned the narrative of exceptionalism, with the U.S. significantly punching above its weight in terms of attracting global investors (Figure 1).

The GDP growth pattern reversed in Q1 of this year, with the U.S. contracting and the euro area registering a phenomenal 0.6% quarter-over-quarter growth rate. The difference flatters to deceive however, as the shift largely reflects the frontloading of trade, further magnified by volatile Irish data. As a result, **our view remains that growth in 2025 will generally converge at just above 1% in most major developed economies—including the U.S. and the euro area**—on the assumption that the maximalist U.S. tariffs announced in early April are averted.

Although labour markets are also easing, their resilience remains key to our "muddle through" narrative. This resilience is underpinned by structural labour market improvements in several euro area economies, the outperformance of peripheral economies, such as Spain and Greece, and Germany's ramped-up spending on defence and infrastructure. These factors culminate in a relatively positive outlook for the euro area vis-a-vis a slowing U.S. economy against a backdrop of tighter immigration controls.

In terms of monetary policy, the ECB is in an enviable position given that inflation is now back to the 2% target where it is expected to stay over the forecast horizon. Moreover, tariffs are increasingly viewed as deflationary outside of the U.S. considering the receding risks of escalating retaliatory tariffs. Having cut its policy rate by

**Figure 1: The U.S. global share of fixed income, equities, and FX reserves easily outpaced its GDP share in recent years.** (U.S. share of global markets and global GDP)




Source: SIFMA, Macrobond as of June 2025; shares of fixed income, equities, and FX reserves are as of 2023.

200 bps from its peak to 2%, significant ECB easing should support the euro area economy through these turbulent times. **Indeed, our view is that the ECB is likely to lower rates marginally further in 2026 absent any marked deterioration in the labour market.** In a scenario of deteriorating labour conditions and inflation credibility holding around the 2% target, the ECB has the space for more aggressive cuts if needed.

The ECB's policy flexibility stands in contrast to the Federal Reserve. An airgap remains between recent U.S. inflation prints of around 2.5% and the 2% target. Moreover, U.S. tariffs applied to final consumption goods coming from Europe and China pose risks to the inflation outlook that are not mirrored elsewhere. Our base case assumes U.S. inflation will rise further above target and closer to 3% within 12 months. As such, the Fed is expected to remain on hold for now. **We see two more 25 bps cuts over the next 12 months as the most likely outcome.**

The deterioration in U.S. fiscal conditions is also generating more concern than those in the euro area, particularly in a scenario of economic slowing. The starting point for debt-to-GDP and the deficit is significantly higher in the U.S. than in the euro area (see the following box on the U.S. fiscal outlook), underscoring the relative pressure at the back of select DM yield curves. Most of the euro area, except for France, is credibly on track towards a 3% deficit in keeping with EU fiscal rules. That target also serves as a threshold to monitor as economic and fiscal conditions evolve. Previous hotspots, such as Portugal, have significantly improved fiscal sustainability in recent years. In contrast, the U.S. debt-to-GDP trajectory is set to rise above that of Greece (Figure 2).

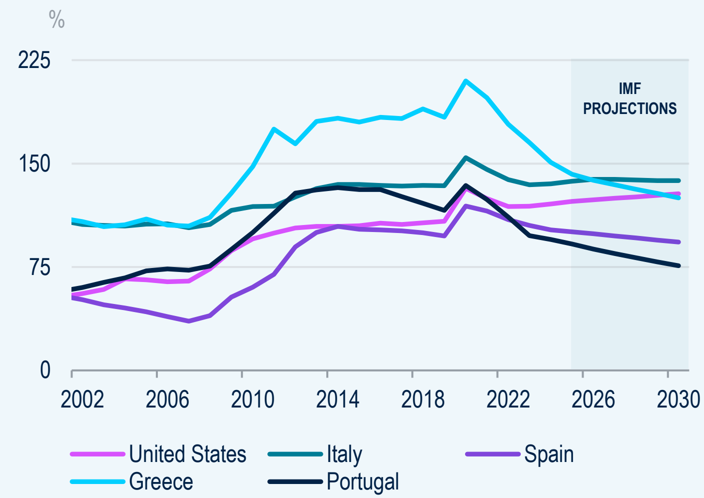
The bottom line is that U.S. policy space looks more limited than in Europe, and the risks of above-target inflation are greater. These developments have surfaced alongside increasing questions over U.S. institutional credibility as well as general investor attractiveness over and above fiscal sustainability concerns.

For example, as a multinational institution, the ECB is arguably the most independent major central bank in the world. This stands in contrast to recent perceived threats to Fed independence and the prospect of an early replacement of Chair Powell. The EU is also a much more open economic region, with significantly more trade agreements than the U.S. **As a result, more traded goods are invoiced in euros than in U.S. dollars.** With that said, [the size of Europe's capital markets] remains a limiting factor and will ultimately curb the extent to which investors are likely to disengage from U.S. markets.

## Japan—Delayed Return to Normalisation

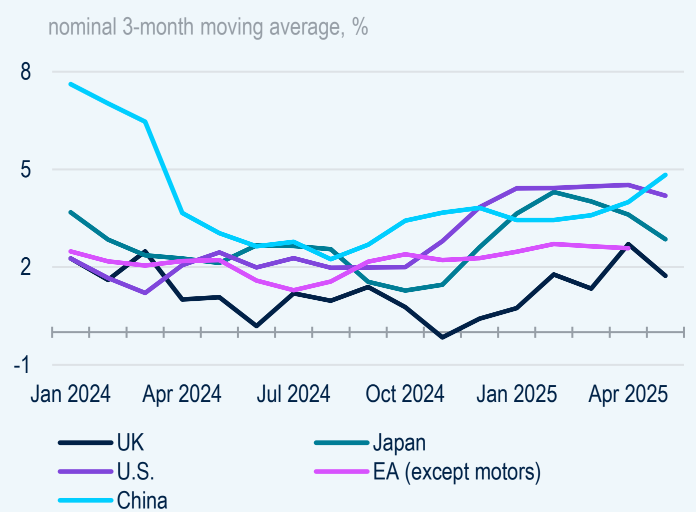
At its June policy meeting, the Bank of Japan held rates at 0.5%, but the tone and signalling was more dovish than expected. The recent data flow indicate that, although the Japanese economy continues to reflate, nervousness around trade

**Figure 2: The U.S. debt-to-GDP ratio is approaching levels of other previously-stressed sovereigns, such as Greece**




Source: Macrobond as of June 2025

**Figure 3: Japan's year-over-year retail sales have improved recently, joining levels set by the U.S. and China**




Source: Macrobond as of June 2025

uncertainty has clearly cooled enthusiasm for further near-term policy normalisation.

Trade uncertainty and tariff effects are expected to filter through to the macro data in the second half of this year, offering policymakers a clearer way forward. A key concern is the potential squeeze on corporate profits from much higher-than-expected U.S. tariffs, which could consequently translate into weaker pay growth going into 2026. This dynamic would threaten a self-sustaining convergence to the 2% inflation target. **As a result, we expect the Bank of Japan to remain on hold for the remainder of this year.**

That said, the dynamics of the Japanese economy continue to hold up. The theme of resilient labour markets and recovering real wages—as seen in other major developed economies—is true for Japan as well. As a result, consumer demand remains an important contributor to our outlook of acceptable growth of 1.1% in 2025 (Figure 3). Inflation remains robust by Japanese standards, underpinned by high food prices that are likely to feed into inflation expectations and wage demands. **This suggests that as uncertainty potentially recedes next year, we expect the Bank of Japan to return to its normalisation path.**

### China—Emphasis on the Domestic

In China, the managed deflation of its real estate bubble continues. Property investment continues to decline, and house prices have fallen further. In such an environment, it is not surprising that credit demand, including total social financing, remains weak. In the past, this would have signalled a challenging outlook given the tight link between credit expansion in China and GDP growth.

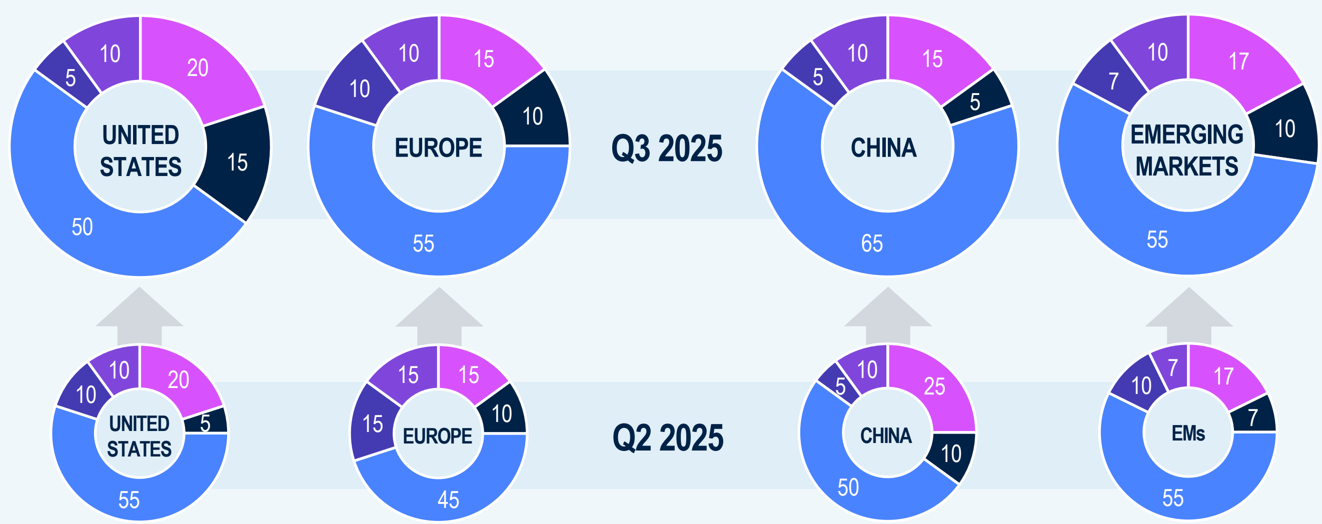
However, government support aimed at the consumer, such as trade-in incentives and e-commerce discounts, have provided economic support. The Geneva trade truce offered another near-term fillip to the economy, though industrial production and fixed asset investment remains weak. This weakness undoubtedly reflects the newly erected trade barriers, not just from the U.S. via higher tariffs, but also from the EU, which recently launched an import surveillance task force to monitor potentially harmful import trends. Alongside targeted fiscal support for consumers, China is also benefiting from monetary easing. Inflation remains below zero, and even recent oil price volatility is insufficient to overcome deflation. **As a result, we see further easing in the second half of 2025.**

This policy easing should also bolster emerging market economies and reinforce the narrative of enduring EM resilience as observed in the following EM section.

**Q3 Macroeconomic Scenarios**

PGIM's Q3 '25 economic scenarios feature outcomes on both sides of the distribution with a "muddle through" base case (% probability).

- Recession
- Mild Stagflation
- Muddle Through (base case)
- Nominal GDP Boom
- Productivity Boost




Source: PGIM. *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.

## SPOTLIGHT A Big, Not-so-Beautiful U.S. Deficit

Amongst the litany of U.S. developments this year, the recently signed tax-and-spending bill—as well as its implications for the spiraling deficit—will have long-lasting effects.

The bill's permanent extension of the TCJA tax cuts, amongst other provisions, could deepen the deficit from a baseline of 6% of GDP to 7-8% of GDP by 2034, or an addition to the deficit of more than $3 trillion.[1, 2] As deficit spending continues, debt-to-GDP ratios could reach 117-129% of GDP by the mid 2030s, placing it among the more indebted DM economies as previously indicated in Figure 2.

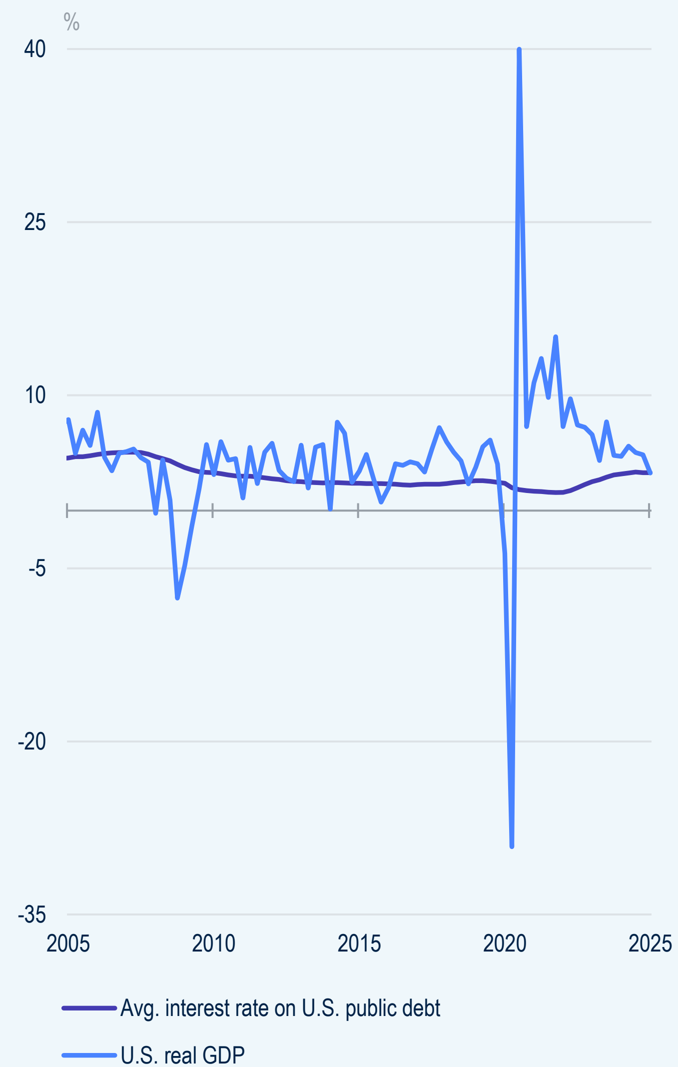
As the debt stock rises, the math of debt sustainability indicates that it becomes more sensitive to deficits, growth, and interest rates. Furthermore, a scenario where the effective rate on government debt exceeds nominal GDP growth introduces the potential for fiscal contraction amid heightened market vigilance. That scenario could again materialize with the post-COVID spike in nominal GDP growth steadily converging to the average interest rate on public debt (Figure 4).

The concept of fiscal space and credibility dovetails with the demand for U.S. Treasury debt and the dollar's share of foreign reserves. While both have been declining on a percentage basis over the past years, recent Treasury auctions have proceeded smoothly on solid demand. Potential pressure on the U.S. fiscal space may manifest in other ways as well, including implications from Ferguson's Law—i.e., great powers do not spend more on interest than defense—and an upward lift to the 10-year Treasury term premium from about 0.70% towards the historical average of 1.45%.[3]

The deficit situation is particularly fraught as a credible, sustained improvement likely involves a third-rail of U.S. politics: reductions to entitlement spending, e.g., social security and Medicare. An improvement would also require an increase in revenue.

While an accompanying boost to economic growth would help deliver that increase—and that potential outcome is within our set of economic scenarios—our base case foresees easing conditions ahead. And based on the contents of the tax-and-spending bill, tax rates appear headed in one direction.

**Figure 4: Nominal U.S. GDP growth vs. average interest rate on U.S. public debt**




Source: Macrobond

[1] The tax cuts were initially part of the Tax Cuts and Jobs Act of 2017.

[2] Deficit estimates from the Committee for a Responsible Federal Budget, Congressional Budget Office, Joint Committee on Taxation and House committees. The CBO assumes average, nominal GDP growth of 3.9%.

[3] The historical term estimate is based on the New York Federal Reserve's ACM estimate on the 10-year Treasury.

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SECTION 5

# GLOBAL SECTOR OUTLOOKS

04

# DEVELOPED MARKET RATES

**Outlook:** Expecting stable to steeper yield curves along with a modest decline in yield ranges on anticipation of eventual rate cuts by the Federal Reserve and the ECB.

■ Despite escalating geopolitical tension paired with the economic disruptions from the tariff situation, developed market interest rates generally remained range bound in the first half of 2025. In the U.S., the 10-year yield traversed an 80 bps range and, after a late-quarter rally, ended Q2 about 35 bps lower than the start of the year. Germany's 10-year bund traversed a range of about 50 bps and ended Q2 nearly 30 bps higher than where it started the year.

■ **The steepening in U.S. and German curves continued with the countries' respective fiscal developments.** Germany is leading Europe's push to lift defense and infrastructure spending, while the recently signed U.S. budget bill is expected to significantly deepen its deficit. The front of the bund curve rallied with the latest ECB rate cuts, while the front of the U.S. Treasury curve rallied on expectations for a second-half restart of the Fed's easing cycle.

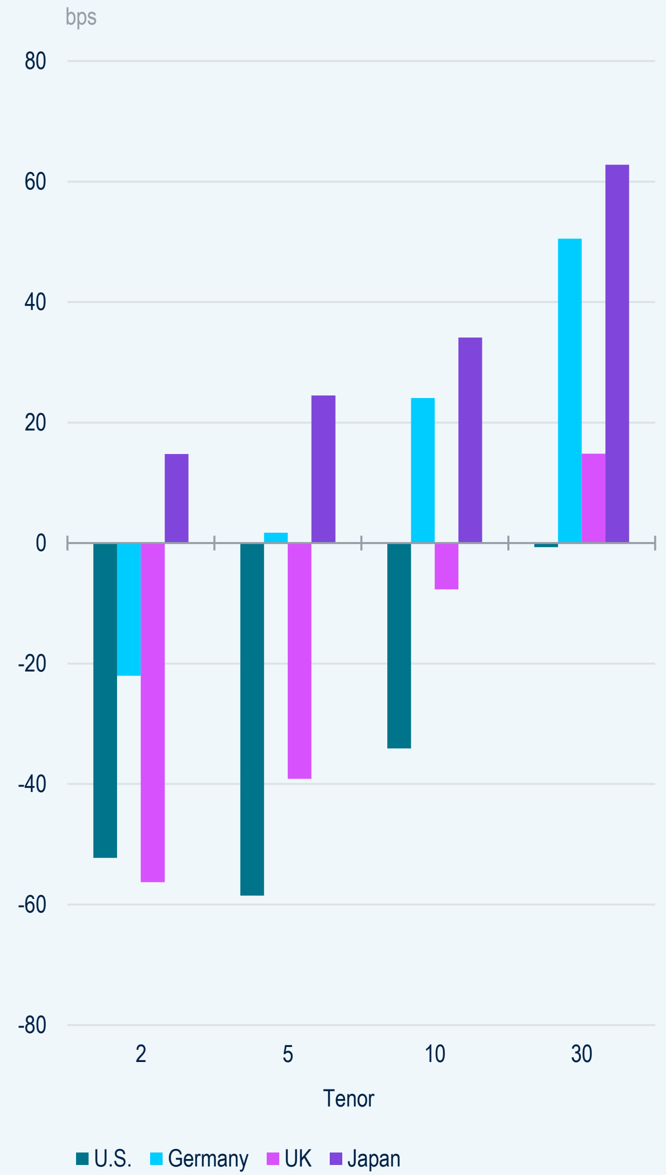
■ The JGB curve also continues to steepen as the Bank of Japan reduces its JGB purchases. In contrast to the Western markets, the negative tone in the JGB market owes to diametrically opposed central bank postures, **with the BoJ set to resume hikes early next year in the face of ongoing, above-target inflation.**

■ With Chair Powell in the latter stages of his term, the market is increasingly focused on FOMC member comments that are aligned with the administration's rate cut admonitions. Indeed, recent dovish comments from Fed Governors Bowman and Waller prompted the market to price a 20% probability of a cut as soon as July—a probability subsequently dashed after the June payroll report.

■ While a July rate cut may be premature, the market is pricing more than 2.5 cuts for the balance of the year, a more aggressive path than Fed officials communicated in the June "dot plot." **Despite the gyrations, market pricing continues to center on a Fed path to 3% by the middle of 2026, which coincides with the Fed's long-term "dot" projection.**

■ Finally, the comment period regarding the Fed's supplementary leverage ratio on large banks' holdings, including Treasuries, opened in late Q2. Despite anticipation of improved trading conditions on cash Treasuries, the market reaction was relatively subdued, but bears watching as implementation approaches this autumn. Ultimately, it seems that the Fed is moving towards using SLR as a backstop, instead of a binding constraint, and the changes in regulation should promote improved Treasury intermediation.

**The YTD steepening along DM Yield Curves.**




Source: PGIM as of June 30, 2025

# AGENCY MBS

**Outlook:** Carry conditions. After a solid first-half performance, the MBS sector appears unsettled despite a supportive backdrop of subdued origination, consistent demand, and muted prepayment speeds. We prefer a barbell exposure consisting of lower 30-year coupons and production 30-year coupons, while avoiding the middle of the stack. We still favor specified pools for better cashflow and convexity profiles over TBAs.[1]

- MBS posted positive excess returns versus U.S. Treasuries in Q2, with the majority of that performance arriving in June. Year-to-date performance has been muted relative to other sectors of the U.S. Aggregate Index given the headwind from interest-rate volatility. In general, seasoned vintages improved, and production coupons fared better in the coupon stack on demand from collateralized mortgage obligation formation. **Although valuations have firmed from early Q2, we believe that they remain attractive on a Treasury OAS basis.**

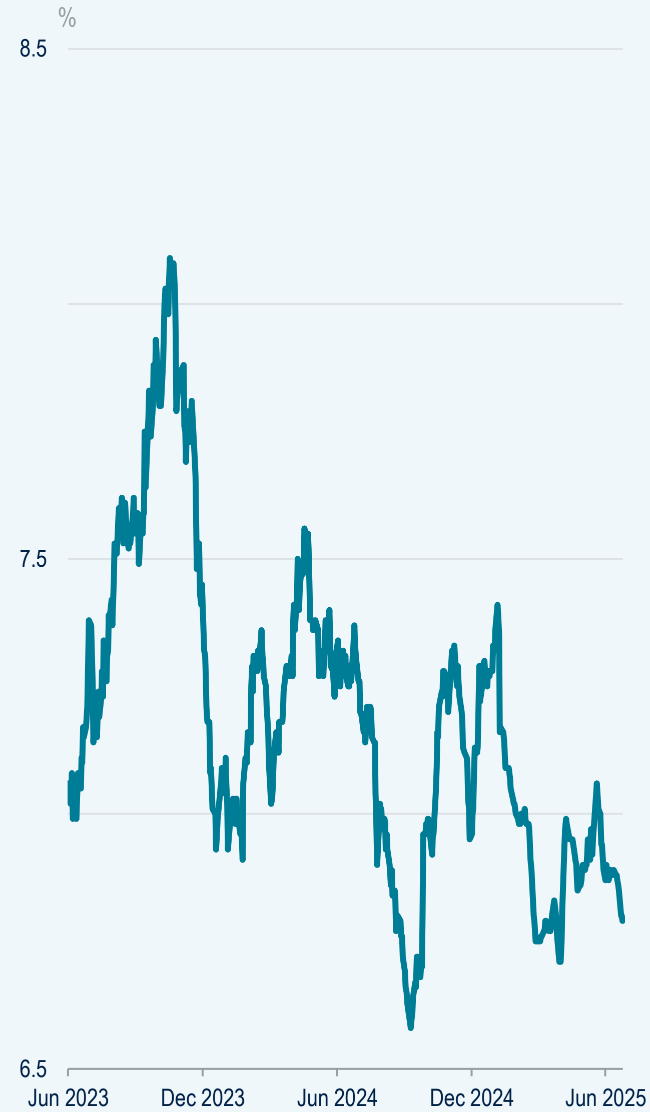
- MBS were trading long given the elevated levels on long-term interest rates. Performance will likely improve if interest rates continue to decline in Q3, but could stall if rates resume an upward push. Notably, the market is pricing in more than two Fed cuts by the end of this year, while the Fed has been patient amid an unclear inflation path.

- We expect prepayment speeds to remain favorable, e.g. lower coupon prepayments have been modestly ahead of expectations, while higher coupon prepayments remain benign. Furthermore, bank demand could continue in the second half of the year due to regulatory relief and consequent balance sheet adjustments. The question of implicit guarantees for Fannie Mae and Freddie Mac seems resolved for the time being. Longer term, the market may continue to brace for these entities to be released from conservatorship.

- We continue to expect net supply to look quite similar to 2024—i.e., less than $200 billion in total net issuance—given persistently high, but recently moderating, mortgage rates (see chart). **Despite typical seasonal patterns, we do not expect a material increase in origination relative to the muted levels observed earlier this year.**

- We expect the Fed to continue allowing MBS to roll off its balance sheet. The Fed is unlikely to again add MBS to the balance sheet in the event of another quantitative easing program.

**30-year mortgage rates continued their year-long decline through Q2.**




Source: Bloomberg

[1] TBA refers to to-be-announced securities, which represent a contract to buy or sell MBS on a specified date.

# CAN DEFENCE BE ESG? A PRAGMATIC PERSPECTIVE

**Europe's geopolitical landscape has changed significantly in recent years, driven by resurgent security threats and the U.S. reduction in regional defence spending. These conditions highlight the need for greater European defence investment to ensure the security and stability of the region. Historically, Europe's defence spending has been well-below the previous NATO target of 2% of GDP. Despite recently announced large commitments from NATO countries, private investment in defence will have a complementary role to play alongside public spending.**

Given the size of the ESG investor base, the eligibility of defence companies within ESG funds can affect both the availability and cost of financing across the sector. At the same time, the inclusion of defence companies brings up numerous ethical considerations given their role in military conflicts. However, the war in Ukraine provides a regional example of the destruction and devastation wrought by an aggressor and underscores the debate about whether defence companies belong in ESG portfolios.

## The Need for Increased Defence Spending

Several key factors underpin Europe's impetus to ramp up its defence spending. First, Europe's aforementioned shortfall on reaching NATO targets on defence spending.

For instance, in 2019, the European Union (EU) as a whole spent approximately 1.6% of its GDP on defence. This underinvestment (see the following chart) has left Europe vulnerable to emerging security threats and reliant on external support for its defence needs. Second, the U.S. has signaled a shift in its geopolitical approach, stepping back from a role that has been a cornerstone of European security since World War II. Third, the ongoing conflict in Ukraine has underscored the need for a robust defence infrastructure to deter aggression and maintain stability in the region.

Despite announcements from EU countries (including a significant commitment from Germany and other NATO countries to raise defence spending to 5% of GDP by 2035), the current level of defence spending remains insufficient, providing an opportunity for private investment to bridge the gap.

## Barriers to Private Defence Investment

While the need for increased defence spending is clear, significant barriers to attracting private investment must be overcome. A recent EU white paper noted that 44% of defence companies cite access to financing as a major concern—a figure much higher than reported by civilian companies. The cost of financing is also an issue, with aerospace and defence companies historically paying a premium on debt capital vs. other industrial issuers of similar credit quality.

PODCAST

### CAN IT BE ESG? A PRAGMATIC TAKE ON DEFENCE

In this episode of Fixed on ESG, we consider whether defence companies should be included in ESG investments, the rising strategic importance of defence, investment barriers, and the potential for ESG-conscious investors to reconsider their exclusion policies.

**Check out PGIM's podcast series, Fixed on ESG.**

The prevalence of weapons-related portfolio exclusions further complicates the situation. Prior to Russia's invasion of Ukraine, some investors, particularly those focused on ESG, adopted a negative stance on weapons producers. However, the devastation in Ukraine has prompted a re-evaluation of this view.

## The Role of ESG Funds

ESG funds now represent over a quarter of all European bond funds and over 13% of global bond funds, according to Bank of America. These funds have large pools of capital, but the widespread application of defence and weapons-related exclusions has severely limited investment in defence company debt. While most government defence spending is intended as a deterrent, the potential for offensive weapons use complicates the inclusion of defence-related debt in ESG strategies. **The key question then shifts from effect to intent: if weapons are being used solely for deterrence, then exclusion is arguably inappropriate for ESG investors.**

**Therefore, assessing which defence companies are acceptable in ESG strategies requires an understanding of their customers and intentions.** However, defining these criteria is challenging and fraught with subjectivity. Controversial weapons, such as chemical weapons and cluster munitions, are an exception, as producers are unsuitable for ESG-conscious investors.

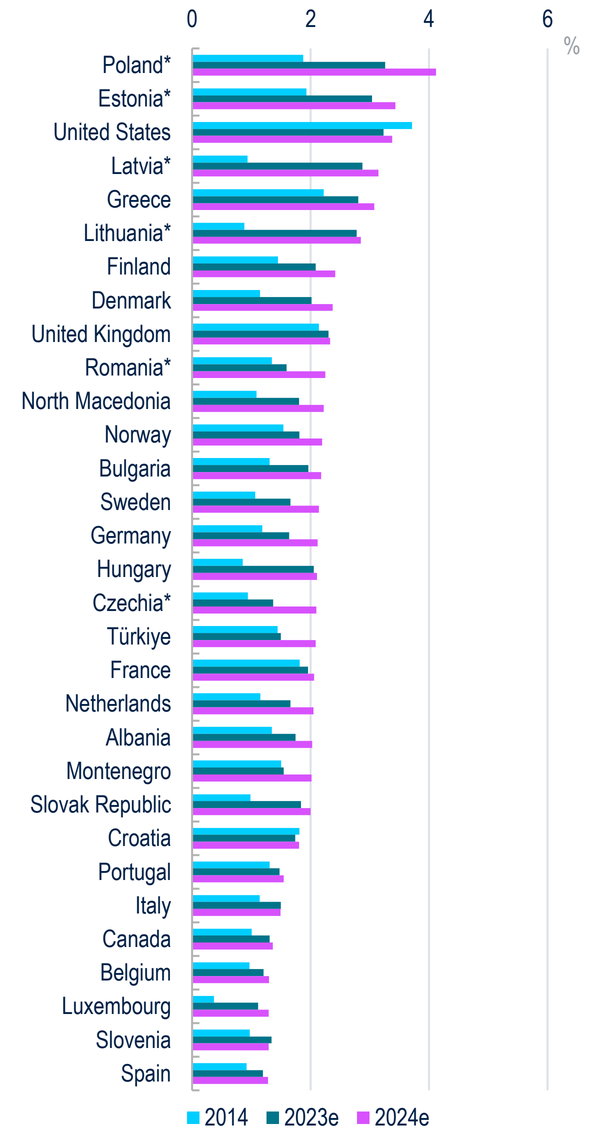
## The Path Forward

Despite these challenges, potential exists to widen the pool of capital to support Europe's increased defence spending. While it may not be appropriate for all ESG investors to fund defence companies, there is a large cohort of ESG-conscious investors for whom it may be appropriate. In Europe, funds classified as Article 8, totaling approximately €5.9 trillion, are often assumed to be the equivalent of ESG funds. **But in reality, there's a wide variety of ESG goals and approaches within these products.**

There are also many ESG funds that prioritize financial returns while integrating ESG risks, and in these vehicles, defence company exclusions may be inappropriate. These funds focus on companies that contribute to financial returns, and while ESG-related risks pertain to defence companies, these may be offset by other factors, such as increased demand for defence.

We expect that for many ESG investors, particularly those in Europe, the rapidly changing geopolitical and security environment means that certain defence companies may no longer need to be excluded. It is only the more ambitious investment vehicles with an explicit good-for-the-world objective—on top of the financial one—with terms, such as "sustainable," "impact," "ESG," where caution may be more warranted. In practice, investors need to pay close attention to their exclusion policies to ensure that they remain aligned with their preferences and values, particularly given the likely increase in the defence industry's financing needs.

### Defence spending as a share of GDP




Source: NATO. Based on 2015 prices and exchange rates. * National laws or political agreements which call for 2% of GDP or more to be spent on defence annually.

# SECURITIZED CREDIT

**Outlook:** Carry conditions. Securitized credit spreads generally remain wider YTD, but tighter than historical averages. While credit curves are still flat, valuations at the top of the capital stack remain attractive relative to other fixed income sectors. Our short-term RMBS and ABS outlooks are positive on favorable technicals, but are negative longer term on weakening fundamentals. Our short- and long-term outlooks for CMBS and CLOs are negative on deteriorating fundamentals, such as elevated bank loan default rates, and the likelihood of increasing CMBS defaults. With a high-quality bias, we remain focused on tranches at or near the top of capital structures. Likewise, we remain extremely selective regarding more credit-sensitive positions as the downside risks outweigh the potential rewards.

- In **CMBS**, valuations for most property types have stabilized, and we expect price appreciation to be flat for the year—i.e., likely no V-shaped recovery given long-term interest-rate expectations. We expect delinquency/special servicer/modification rates to continue rising as loans reach final maturity and refi challenges loom. Elevated single-asset, single-borrower (SASB) supply has kept spreads reasonable, and we see value in high-quality deals with structural protections. In conduit, we favor shorter spread duration with five-year AAAs trading wide of similarly-rated 10-year bonds.

**Securitized credit curves generally remain too flat to indiscriminately travel down the capital stack.**


Source for CMBS and ABS credit curve: JPMorgan ABS, CMBS Indices. Dates January 3, 2012 to June 13, 2025. Source for CLO Credit Curve: PGIM. SI dates vary. CLO AAA, AA from December 22, 2014. CLO A, BBB, BB from December 29, 2017. Source for RMBS Credit Curve: JP Morgan RMBS Indices. SI dates vary: CRT M1/M2: January 3, 2017; CRT B1: February 28, 2017 and CRT B2: January 4, 2021.

- In **RMBS**, relatively tight inventories and strong demographics continue to support housing values despite historically high mortgage rates and regional pockets of softness in the sunbelt. While delinquencies are increasing among lower-tier borrowers, mortgage credit is solid overall. Non-QMs are the most scalable opportunity to gain mortgage credit exposure, and we favor less negatively convex collateral subtypes. We are adding AAA, second-lien/HELOC deals in the mid-100 bps context that are conservatively underwritten with low LTV ratios.

- **CLO** spreads remain inside of their long-term averages, but still wide of YTD tights (see chart). We expect mixed valuations in the near term, creating opportunities. Senior CLO tranches continue to offer attractive relative value compared to many fixed income asset classes. We are currently seeing the most value in senior tranches, while selectively adding higher-quality mezzanine tranches. While collateral fundamentals remain solid overall—e.g., revenue and earnings growth continued through Q1 2025—tail risks remain, with 10% of the broadly syndicated loan market showing stressed interest-coverage ratios.

- In **ABS**, the consumer remains stretched—especially the non-prime cohort—as they take on more debt due to inflation and above-trend consumption. The effects of student loan repayments also bears watching. That said, we see signs of improvement in newer vintage collateral. Credit spread compression across the capital stack and among issuers remains prevalent. We favor top-tier unsecured consumer and subprime auto issuers, as well as significant risk transfers (SRTs) as they offer attractive carry for short-duration bonds.

# INVESTMENT GRADE CORPORATES

**Outlook:** Carry conditions. We expect IG performance to be supported by strong yield-driven demand in Q3. Meanwhile, in the context of relatively tight spreads, we remain cautious of the risks from slower growth and higher inflation resulting from tariffs and geopolitical unrest.

- **U.S. Spread Expectations:** Since early April, U.S. recession fears have subsided, and spreads now hover near year-to-date tights. Within the context of our Q3 economic "Muddle Through" base case—wherein U.S. growth is between 1.0%-2.5% and inflation is near 3%—**we see spreads heading to a level of 95 bps, +/- 10 bps. An annualized OAS of 95 bps would equate to narrower excess returns as the potential spread widening would offset a full year of carry.**

- **Supportive Technicals:** Yields near decade highs will continue to drive healthy demand for U.S. IG corporates. Gross supply is approaching $900 billion YTD and is expected to total ~$1.5 trillion for the full year. That stated, net supply (~$400-$500 billion) is expected to be manageable. In addition, we expect less issuance of bonds with maturities beyond 10 years amid the current rate environment and limited M&A activity.

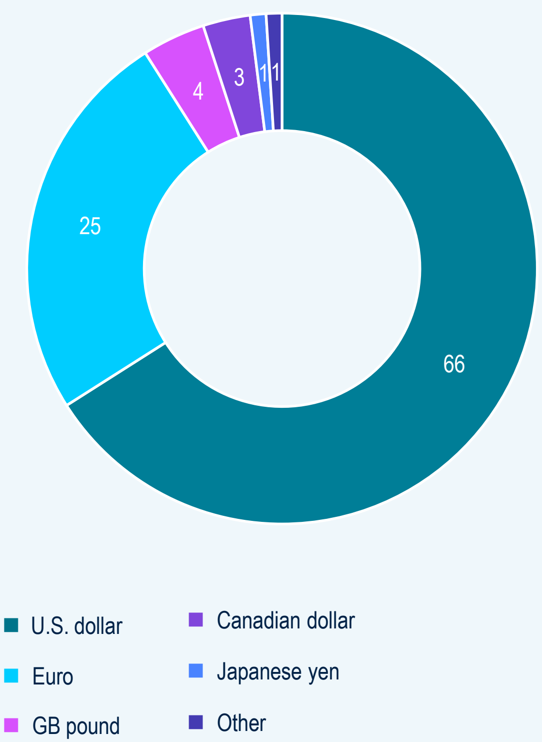
- **Solid Credit Fundamentals:** Q1 revenue grew by 4.0% YoY, and EBITDA margins of 32.4% improved to the highest level since Q1 '22. While many analysts lowered their estimates for Q2 earnings—most notably in the energy and consumer discretionary sectors—they still call for 5% earnings growth on 4% revenue growth (YoY).

- **Shareholder-Friendly Actions:** Increased share buybacks and dividends suggest improving boardroom confidence. Cash paid to shareholders increased by 3.8% (YoY) in Q1. In addition, capex rose 13.8% YoY, led by A-rated tech companies. Despite the current uncertainty, companies will still need to develop long-term strategies as organic sources of growth shrink. As a result, we believe this could lead to a rise in M&A activity in the second half of 2025 as companies seek to take advantage of a more favorable regulatory backdrop.

- **Portfolio Positioning:** In the current environment, we believe there is more opportunity in the short- to intermediate-part of the IG curve. **In addition, we believe a move up in credit quality is appropriate given the high levels of macro uncertainty and considering that BBB-A spreads remain snug.** In terms of sectors, we prefer banks, utilities, as well as select names in energy.

- In **Europe**, the volatility that came after the reciprocal tariff announcement faded on Germany's decision to reform its debt break.

**A regional breakdown of the global IG corporate index (%)**




Source: J.P. Morgan as of June 2025.

- While European IG spreads recovered, those developments have yet to alter Europe's weak growth outlook. In addition, political-related market volatility may reappear in Q3. For example, another bid for a new round of French parliamentary elections could surface in July.

- Technicals remain strong with consistent inflows into Euro IG as investors seek yield or to rebalance assets due to hedging costs. As a result, the moderate supply increase in Q2 was easily absorbed. Heading into the summer months, we expect issuance to slow, further supporting market technicals.

- **Portfolio Positioning:** In our global and Euro IG portfolios, we are moderately cautious of potential risks moving out along the European IG curve. Currently, there is a ~12 bps differential between the U.S. and the Euro market. To us, this seems reasonable given Europe's fragile growth expectations. In terms of currency, our risk-on positions in USD and Euros are relatively light with an emphasis on carry.

# GLOBAL LEVERAGED FINANCE

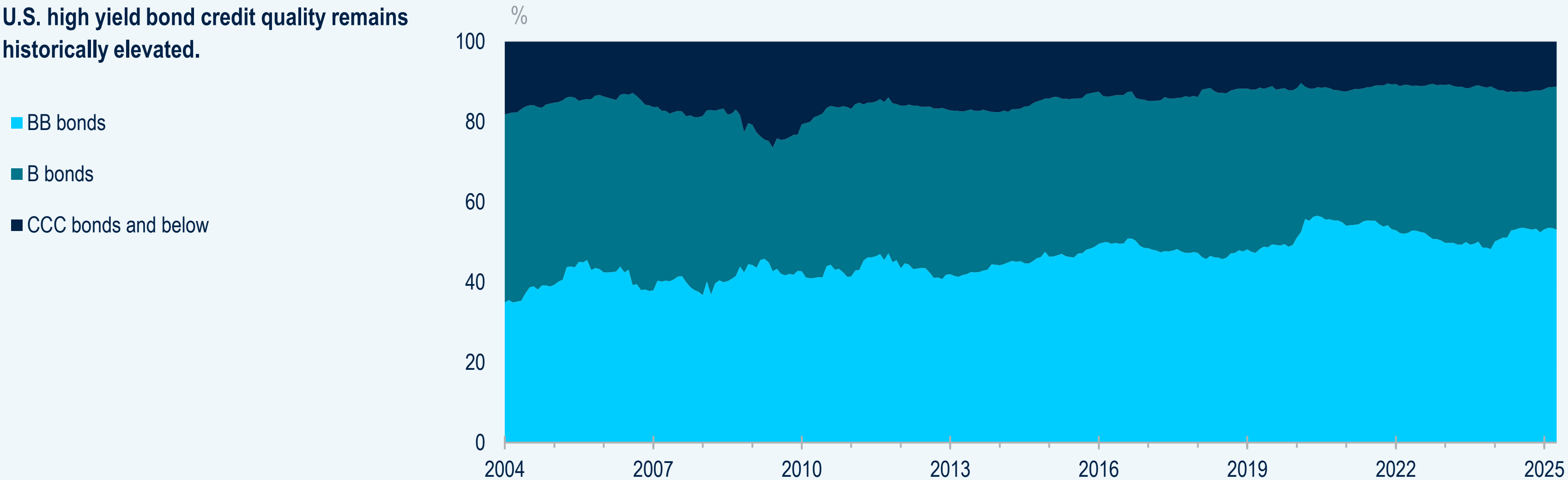
**Outlook**: Carry conditions. We expect global leveraged finance spreads to continue grinding tighter on strong technicals and an improving macro environment. While more constructive than Q2, we maintain our close-to-home defensive positioning in U.S. high yield bonds and loans as well as underweights to cyclicals and other tariff-impacted names in Europe.

- **U.S. High Yield:** While spreads have compressed to near-historic tights, they may continue to grind tighter through the summer on solid technicals and a sound credit environment. Although tail risks abound from U.S. fiscal and trade policies, as well as geopolitical tensions on multiple fronts, the domestic exposure of high yield issuers generally helps cushion them from global disruptions. The market's improving credit quality also warrants mentioning as BBs comprise more than half of the market compared to 40% as of 2004 (see chart). Furthermore, the Federal Reserve "put" remains in play should economic data deteriorate. However, rate cuts could lag economic conditions if inflation drifts higher from still-elevated levels.

- We expect the strong technical environment to persist amid light new issuance, manageable maturities, attractive yields, and defensively positioned active managers. Although Q1's net supply deficit swung to a surplus in Q2, primary market activity is expected to remain light as issuers continue to demonstrate balance-sheet prudence. That said, the market's looser documentation standards indicate that the volume of distressed exchanges could increase.

- **We remain overweight short-duration bonds, and we are reducing our underweight to high-quality issues.** Looking at sectors, we are overweight home construction, telecom, and midstream energy, and underweight technology, media & entertainment, and retailers & restaurants. Recent risk reductions (but still overweight) have included positions in telecom, building materials & home construction, and cable & satellite. We're also adding risk in midstream energy as well as reducing an underweight to technology.

**U.S. high yield bond credit quality remains historically elevated.**




Source: Bank of America

■ The **U.S. leveraged loan** market started Q3 on solid ground, with improving performance, positive retail fund flows, and only about 46% of the market trading at or above par. Demand remains firm for relatively light new issuance with proceeds slated for a variety of purposes, including dividends, M&As, and LBOs. While Q2's gross issuance was much lower than in Q1, the use of proceeds in Q2 was more balanced, with nearly half supporting acquisitions, dividends, and general corporate purposes. **Furthermore, the trend of private credit taking out broadly syndicated loans (BSL) has turned into a two-way street, with loans moving between the public and private markets as sponsors explore both avenues for attractive terms.**

■ While performance rebounded in Q2 from a muted Q1 (see returns table), we have only slightly tempered our 2025 total return forecast. **Our forecast is supported by high all-in current coupons and yields, strong CLO formation, and continued inflows from institutional and retail investors. Our minor adjustment is due to sharply higher net issuance volume and easing SOFR rates bringing coupons lower as the year progresses.**

■ 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 deep, fundamental credit research/modeling is becoming increasingly important to credit selection. **To that end, the avoidance of defaults will likely be the biggest driver of alpha over the next 12-24 months.**

■ After widening aggressively at the beginning of April, spreads for **European high yield bonds and loans** ended Q2 at the tight end of their three-year ranges. We expect European leveraged finance markets to remain resilient in Q3, supported by limited net new supply, persistent inflows, and continued CLO formation. Whilst macro risks remain elevated, geopolitical tensions and tariff impacts have eased, providing a more supportive backdrop for spreads to grind tighter this quarter.

■ Although we are cautiously constructive and running risk above market levels, we remain generally underweight cyclical, consumer discretionary, and tariff-impacted businesses. We believe careful credit selection and a focus on idiosyncratic relative value opportunities will continue to be rewarded.

# EMERGING MARKET DEBT

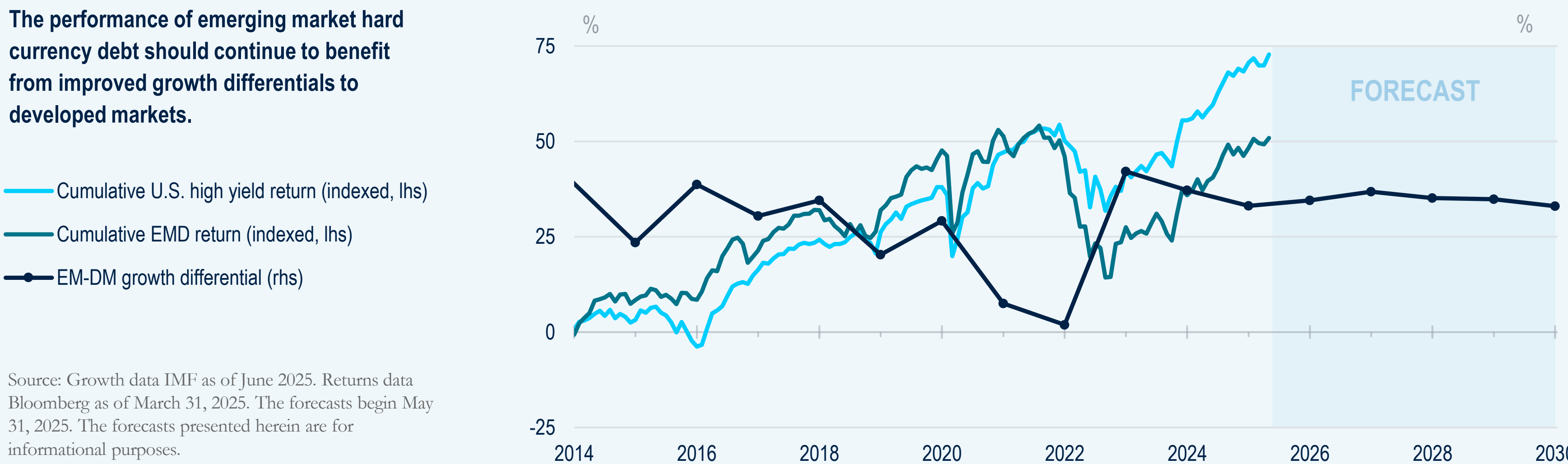
**Outlook:** Carry conditions and modest spread tightening. Despite an uncertain global backdrop, we remain focused on fundamentals and idiosyncratic opportunities. EMD technicals also remain supportive, and yields stand out in a world of compressed spreads and tight valuations. Geopolitics frame tail risks on either side of the distribution. We remain relative-value focused and cautious around spread risk, but sense mounting tailwinds in the sector. EM rates have scope for continued outperformance as the U.S. dollar maintains its weakening trend. EM corporates offer diversification opportunities.

■ **EM Sovereigns/Spreads:** In a fragmented global landscape, hard currency EM debt offers a rare combination of yield, diversification, and macro resilience. With U.S. policy uncertainty rising and global capital flows shifting, the potential for EM outperformance could present an opportune time to reassess strategic allocations and exposures to this under-owned asset class. **While we see opportunities across local debt, hard currency debt has the benefit of isolating credit and macro exposure from local currency volatility.**

■ EM hard currency spreads are at the tight end of their YTD range, with broad dispersion persisting between rating categories. From a valuation perspective, in a world of compressed credit spreads across fixed income, the yields in EM hard currency standout, particularly given the stable-to-improving credit trajectory in many emerging markets. However, clear headwinds persist with continued uncertainty regarding the timing and magnitude of tariffs as well as their impact on global growth, flows, and U.S. rates. **It remains notable how the market continues to shrug off some of these risks, preferring instead to focus on the sector's longer-term, compelling investment thesis.**

■ Geopolitics, the re-mapping of the world order, and consequences of related growth shocks, help define potential tail risks in the sector, which exist on both sides of the distribution. Technicals remain supportive for the asset class as dedicated investors are generally light risk, and crossover investors are attracted to its yield and diversification. The global context appears to be moving away from the narrative of U.S. exceptionalism towards one of global rebalancing as the U.S. continues to expand

**The performance of emerging market hard currency debt should continue to benefit from improved growth differentials to developed markets.**




Source: Growth data IMF as of June 2025. Returns data Bloomberg as of March 31, 2025. The forecasts begin May 31, 2025. The forecasts presented herein are for informational purposes.

on a phase of more meaningful fiscal deficits, trade protectionism, and monetary divergence.

■ By contrast, EMs are benefiting from improving/increasing growth differentials versus the U.S. and other developed markets. While we lowered our global growth expectations, we reduced our U.S. growth forecast meaningfully more than our EM forecast. As a result, we expect an EM-DM growth differential of 2.7% for both 2025 and 2026 (see chart). **For context, a growth premium above 2% has historically led to outperformance of EM assets over DM assets, while a growth premium below 2% has led to underperformance.** Moreover, a strong U.S. dollar has contributed to stronger U.S./DM assets over the past 10-15 years. With that strength potentially waning, cyclical tailwinds to EM outperformance are building.

■ EM fundamentals have remained resilient and outperformed DM counterparties recently. While fiscal deficits remain, twelve-month rolling fiscal deficits are improving in many countries—despite some fiscal weakness in Colombia, Panama, El Salvador, and Romania—keeping public debt trajectories stable and driving credit upgrades across numerous EM sovereigns. A weaker U.S. dollar would naturally reduce debt-to-GDP ratios across EM sovereigns and create a more favorable external environment. The trajectory of EM central bank policies also remains supportive. Many EM central banks front-loaded hikes in the post-COVID environment, giving them room to ease policy and support domestic demand.

■ **Given the high all-in carry of the Index (which can offset 95 bps of spread widening without any move in core rates), we believe investors are being fairly compensated for the current uncertainty and expect total returns to skew positive.** In a negative global growth shock, rates should help drive performance in hard currency assets. In a scenario where EM growth remains positive, carry alone should provide attractive returns.

■ We continue to prefer high-carry, yet resilient, BB issuers, such as Brazil, Serbia, Guatemala, Ivory Coast, Colombia, Dominican Republic, and Costa Rica. We also prefer idiosyncratic stories in Argentina, Ecuador, Ghana, El Salvador, Egypt, Zambia, and Angola.

■ In addition, we see relative-value opportunities within individual higher-quality countries. Despite some domestic headwinds, we see defensive opportunities in Mexico (e.g., we are underweight the sovereign, but overweight Mexico City Airport's secured debt and down the curve in Pemex). In aggregate, Kazakhstan is a small overweight as we maintain a large overweight to KazMunayGaz, but nearly an almost equal underweight to the sovereign. Saudi Arabia is an overweight through the sovereign as well as through the quasi-sovereign Aramco. Within the UAE, we have overweights in DP World, Galaxy Pipeline, Sharjah, and Dubai. Romania also remains an overweight.

■ **EM Corporates:** Corporate spreads were flat in Q2, with a slightly positive spread return. Significant differentiation across sectors and ratings surfaced with financials/pulp & paper outperforming while oil & gas underperformed. BBB/BB rated issuers outperformed B rated issuers. Looking forward, EM corporates may continue climbing a wall of worry in Q3. While spreads are at the tighter end of the historical range, we believe the attractive yields and relative value will continue to drive returns.

■ From a geographic perspective, Asia has performed well in 2025 against the backdrop of a cyclical upturn in China/Hong Kong and the structural growth story in India. Meanwhile, Latin America performance has been mixed, with attractive valuations offsetting the heavy cyclical/commodity exposures. Europe has been supported by potential fiscal expansion, while Africa has shown some weakness, with lower-rated issuers underperforming.

■ While leverage has picked up, fundamentals remain resilient, and we expect EM corporate high yield defaults to remain below the ~4% historical average. The recent weakness in the U.S. dollar improves EM corporates' ability to service their U.S. dollar-denominated bonds amidst a general loosening in local financial conditions. Gross issuance has been higher than expected—driven by the Middle East and Latin America—while net financing is still close to flat, supporting technicals. There are some notable exceptions: in India, issuers are choosing to issue in local markets due to lower rates, and supply has been limited in the U.S. dollar bond market, keeping spreads anchored.

- EM corporates continue to offer diversification opportunities, and the asset class has experienced fewer idiosyncratic surprises over the last 12-18 months. Non-dedicated investors have shown appetite for the asset class given the spread pickup, which looks even more attractive given the rally in U.S. high yield. We still see the best value in BB and longer-dated BBB issuers. We are looking to add risk in select BB+/ BBB- laggards, such as Mexican bank tier-twos, Korean insurers, and Hong Kong perpetuals. Risks to the asset class include sustained geopolitical tensions and/or a U.S. recession.

- **EM Local Rates:** On one hand, the broad U.S. dollar weakness has provided a tailwind for emerging market currencies and brightened the outlook for monetary easing. On the other hand, the focus has quickly shifted from weaker global growth to higher fiscal deficits, resulting in still-elevated core rates and steeper yield curves worldwide. In Q2, EM local bonds outperformed U.S. Treasuries—a trend we expect to continue in Q3. On an absolute basis, it will be hard for EM duration to repeat the strong performance of Q2 without the support of lower U.S. Treasury yields, which were materializing as Q2 concluded. **In Q3, we prefer alpha opportunities in select bottom-up stories, which should benefit from a stable to depreciating U.S. dollar.**

- The main risk to our constructive outlook is further volatility in the Middle East and a resulting risk of substantially higher oil prices, along with further negative shocks to trade and growth.

- Within Latin America, we are maintaining the following overweights: Brazil, as the country has signaled the end of its rate hiking cycle; Mexico due a lower terminal rate than the market implied rate; Peru due to its steep yield curve and attractive hedged yields; and Colombia due to an expected delay in rate cuts. Within CEEMEA, we are overweight South Africa due to the attractive risk premium in the 10- to 15-year tenors. Within Asia, we are overweight Korea, which still has room to cut, as well as Indonesia amid a stabilization in its currency and lagged performance versus peers.

- **EMFX:** Every EM currency posted positive performance in Q2 (led by LatAm and Europe) against the backdrop of broad U.S. dollar weakness—even in the face of elevated U.S. Treasury real yields (see returns table). **Looking ahead, we remain relative-value focused and expect a weakening (but mixed) U.S. dollar due to several factors: tariffs may weigh on U.S. growth, prompting additional rate cuts that exceed those from other central banks; EU fiscal measures could offset the growth downside, leading to higher growth vis-a-vis the U.S.; and more stimulus measures from China are likely to result in a stable or improved economic backdrop, which could keep volatility low and support higher-beta, cyclical currencies.** Risks to this outlook include the possibility of a U.S. recession or global growth slowdown, increased geopolitical risks, and EM fiscal concerns in select countries, such as Brazil, Colombia, and Poland.

- In terms of positioning, we remain focused on relative-value opportunities, with high-carry long positions in BRL, MXN, TRY, INR, EGP, and ZAR, and low-carry short positions in TWD, KRW, CNH, THB, and CZK. We also have a small, short USD bias. From current levels, we have doubts that TWD and KRW can continue to outperform into year-end due to the highly negative implied yield (-6%) of TWD and the now normalized hedging ratios among insurance entities. **Unless U.S. Treasury yields move lower on a relative basis, we believe the high-carry currencies will outperform going forward.**

# MUNICIPAL BONDS

**Outlook:** Carry conditions. Municipal bonds provide a great late-cycle haven considering that they are more immune to downturns as fundamentals (e.g., tax collections, balance sheets, issuer upgrades) remain strong. That stated, technicals continue to drive the market, and valuations have improved due to heavier supply. We expect valuations to stay wide, making the "muddle through" trade more attractive.

- **Tax-exempt Munis**: Although munis have underperformed Treasuries YTD, the steepness of the M/T yield curve has become even more attractive, holding steady in the 90th percentile of cheapness over the last 10 years at +120 bps between 10s/30s.

- **Supply/Demand**: Last year's issuance totaled a record $500 billion. We expect issuance in 2025 to exceed this by 15%. However, with the legislative speculation about munis' tax exemption resolved for now, issuers may feel less urgency to issue debt in the near term, possibly leading to a supply slowdown.

- On the demand side, retail investors have shown that they are attracted to the overall, taxable equivalent yields on munis—especially as corporate spreads remain relatively tight. Outflows from the muni market following April 2nd were quickly reversed and turned into five straight weeks of positive flows ($4.7 billion). In addition, June-August reinvestment is estimated to reach ~$130 billion.

- **Fundamentals**: Municipal reserves were built up over the COVID era, and they remain elevated. Tax collections grew 4.5% in 2024 and are expected to grow 1.9% in 2025, in line with GDP. Upgrades continue to outpace downgrades by 1.4x. Given that headlines may continue to act as headwinds, we are monitoring the local government, healthcare, and higher education sectors.

- **Taxable Munis**: Limited supply continues to support technicals on the taxable muni side. However, two of the largest sectors in taxable munis are higher education and healthcare. As a result, we could see wider spreads in these sectors.

- **Positioning**: Due to rate volatility, we seek to build a durable portfolio that hits our alpha targets while maintaining the duration of the index. We seek to complement this with rate curve flatteners as they look more attractive given the steepening of the M/T yield curve (see charts). In terms of credits, we are avoiding names that are more susceptible to Medicaid cuts (e.g., healthcare providers that have higher Medicaid payer mixes), as well as universities that have high leverage, weak balance sheets, and/or a reliance on endowment revenue.

**Tax-exempt Muni YTD Total Returns by Maturity and Quarter-over-quarter change in Muni/Treasury yield ratios**


Source: J.P. Morgan, as of June 6, 2025. (Research - Municipal Markets Weekly - J.P. Morgan Markets)

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 1-5 with an accompanying description that indicates our expectation for the sector's total excess return.[1]

**Market Score**

| Sell Off | Correction | Carry | Modest Tightening | Bull Market |
|---|---|---|---|---|

| Sector | Short-term Outlook | Long-term Outlook |
|---|---|---|
| **DM Rates** | Expecting stable to steeper yield curves along with a modest decline in yield ranges on anticipation of eventual rate cuts by the Federal Reserve and the ECB. | U.S.; Europe; UK; Japan |
| **Agency MBS** | Carry conditions. After a solid first-half performance, the MBS sector appears unsettled despite a supportive backdrop of subdued origination, consistent demand, and muted prepayment speeds. We prefer a barbell exposure consisting of lower 30-year coupons and production 30-year coupons, while avoiding the middle of the stack. We still favor specified pools for better cashflow and convexity profiles over TBAs. | Agency MBS |
| **Securitized Credit** | Carry conditions. Securitized credit spreads generally remain wider YTD, but tighter than historical averages. While credit curves are still flat, valuations at the top of the capital stack remain attractive relative to other fixed income sectors. Our short-term RMBS and ABS outlooks are positive on favorable technicals, but are negative longer term on weakening fundamentals. Our short- and long-term outlooks for CMBS and CLOs are negative on deteriorating fundamentals, such as elevated bank loan default rates, and the likelihood of increasing CMBS defaults. With a high-quality bias, we remain focused on tranches at or near the top of capital structures. Likewise, we remain extremely selective regarding more credit-sensitive positions as the downside risks outweigh the potential rewards. | CMBS; CLOs; ABS |
| **Global IG Corporates** | Carry conditions. We expect IG performance to be supported by strong yield-driven demand in Q3. Meanwhile, in the context of relatively tight spreads, we remain cautious of the risks from slower growth and higher inflation resulting from tariffs and geopolitical unrest. | U.S. Corps. 1-10; U.S. Corps. 10+; European Corps. 1-5; European Corps. 5+ |
| **Global Leveraged Finance** | Carry conditions. We expect global leveraged finance spreads to continue grinding tighter on strong technicals and an improving macro environment. While more constructive than Q2, we maintain our close-to-home defensive positioning in U.S. high yield bonds and loans as well as underweights to cyclicals and other tariff-impacted names in Europe. | 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** | Carry conditions and modest spread tightening. Despite an uncertain global backdrop, we remain focused on fundamentals and idiosyncratic opportunities. EMD technicals also remain supportive, and yields stand out in a world of compressed spreads and tight valuations. Geopolitics frame tail risks on either side of the distribution. We remain relative-value focused and cautious around spread risk, but sense mounting tailwinds in the sector. EM rates have scope for continued outperformance as the U.S. dollar maintains its weakening trend. EM corporates offer diversification opportunities. | Sov. Hard Currency IG; Sov. Hard Currency HY; Local rates[2]; EMFX[2]; Corps. IG; Corps. HY |
| **Municipal Bonds** | Carry conditions. Municipal bonds provide a great late-cycle haven considering that they are more immune to downturns with stickier credit quality as fundamentals (e.g., tax collections, balance sheets, issuer upgrades) remain strong. That stated, technicals continue to drive the market, and valuations have improved due to heavier supply. We expect valuations to stay wide, making the "Muddle Through" trade more attractive. | 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 based on expectations for total excess returns.

## SUMMARY OF MARKET PERFORMANCE

| Sector | | Subsector | Spread change (bps) Q2 | SOFR OAS 6/30/25 |
|---|---|---|---|---|
| CMBS | CMBS: Conduit AAA | First-pay 10-year | 3 | 143 |
| | CMBS: Conduit BBB- | BBB- | 105 | 625 |
| | CMBS: SASB –Sr. | AAA | 5 | 150 |
| | CMBS: SASB – Mezz | BBB- | -10 | 245 |
| | CMBS: Agency Multifamily | Senior | 9 | 95 |
| Non-Agency RMBS | Legacy | RPL Senior | 27 | 175 |
| | Legacy | '06/'07 Alt-A | 5 | 245 |
| | GSE Risk-Sharing | M2 | -20 | 145 |
| CLOs | CLO 2.0 | AAA | 4 | 128 |
| | CLO 2.0 | AA | -15 | 160 |
| | CLO 2.0 | BBB | -25 | 280 |
| ABS | Unsecured Consumer Loan ABS | Seniors | 0 | 128 |
| | Unsecured Consumer Loan ABS | Class B | 10 | 163 |
| | Refi Private Student Loan | Seniors | 5 | 138 |
| | Credit Card ABS | AAA | 5 | 73 |

Source: PGIM.

| | Total Return (%) | | Spread Change (bps) | | OAS (bps) |
|---|---|---|---|---|---|
| | Q2 | YTD | Q2 | YTD | 6/30/25 |
| U.S. Corps. | 1.82 | 4.17 | -11 | 3 | 83 |
| European Corps. | 1.81 | 1.80 | -6 | -10 | 92 |

Source: Bloomberg.

| | Total return (%) | | Spread / yield change (bps) | | OAS (bps) / yield % |
|---|---|---|---|---|---|
| | Q2 | YTD | Q2 | YTD | 6/30/25 |
| EM Hard Currency | 3.32 | 5.36 | -27 | -3 | 322 |
| EM Local (Hedged) | 2.75 | 4.41 | -29 | -38 | 6.01 |
| EMFX | 7.09 | 10.44 | -170 | -271 | 5.50 |
| EM Corps. | 1.57 | 4.03 | 0 | 25 | 266 |

Source: J.P. Morgan.

| | Total return (%) | | Spread change (bps) | | OAS / DM (bps) |
|---|---|---|---|---|---|
| | Q2 | YTD | Q2 | YTD | 6/30/25 |
| U.S. High Yield | 3.53 | 4.57 | -57 | 3 | 290 |
| Euro High Yield | 1.74 | 2.30 | -25 | 3 | 321 |
| U.S. Leveraged Loans | 2.33 | 2.96 | -39 | -16 | 459 |
| Euro Leveraged Loans | 1.38 | 2.38 | -31 | -9 | 463 |

Source: ICE BofAML and S&P UBS.

| | Total return (%) | |
|---|---|---|
| | Q2 | YTD |
| High Grade Tax-exempt | -0.12 | -0.35 |
| High Yield Tax-exempt | -1.14 | -0.33 |
| Long Taxable Munis Agg. Eligible | -1.94 | -3.38 |

Source: Bloomberg. Represents the Bloomberg Municipal Bond Indices.

Past performance is not a guarantee or a reliable indicator of future results. See Notice for important disclosures. All investments involve risk, including possible loss of capital. An investment cannot be made directly in an index. All data as of June 30, 2025.

**IMPORTANT INFORMATION**

Source(s) of data (unless otherwise noted): PGIM as of July 2025.

**For Professional Investors only. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. All investments involve risk, including the possible loss of capital.**

## INDEX DESCRIPTIONS

#### U.S. INVESTMENT GRADE CORPORATE BONDS

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

#### EUROPEAN INVESTMENT GRADE CORPORATE BONDS

Bloomberg 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.



#### U.S. SENIOR SECURED LOANS

**S&P UBS Leveraged Loan Index:** The 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

**S&P UBS Western European Leveraged Loan Index Hedged**: 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

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

The **S&P 500**® is widely regarded as the best single gauge of large-cap U.S. equities. There is over U.S.D 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately U.S.D 3.4 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.