PGIM FIXED INCOME

1ST QUARTER OUTLOOK

January 2016

PGIM

Market Outlook

In this edition of the PGIM Fixed Income Outlook, **Robert Tipp,** Chief Investment Strategist, looks back at the ups and downs of 2015 and why, despite the likelihood of more rate hikes by the Fed, we believe fixed income is poised for an upside surprise in 2016 (page 3).

Ellen Gaske, Lead G-10 Economist, explains why we anticipate many of the global themes prevalent in 2015 will continue to play out in 2016, including the continuation of U.S. growth, the euro area's struggle to rebalance, and the ongoing, gradual improvement in Japan (page 6).

Sector Views

Corporate Debt (page 8): Our positive view of the corporate market is based on wider spread levels, healthy fundamentals, and the potential for spreads to tighten again.

Global Leveraged Finance (page 9): We see some attractive opportunities in the leveraged finance markets and expect spreads to tighten as fundamentals (ex-commodities) are better than spread levels indicate.

Emerging Markets Debt (page 11): In our selective view, most positions will be concentrated in hard currency bonds from commodity importers and select exporters. We generally prefer sovereigns to corporates. We maintain secondary, long-duration positions in local bonds, the yield of which are near decade highs.

Municipal Bonds (page 12): We hold a positive view based on a supportive technical environment and attractive taxable equivalent yields.

Global Rates (page 13): Opportunistic. We expect the term risk premium in the U.S. Treasuries market to decline and TIPS to outperform nominal Treasuries. We see a risk for higher JGB yields in the belly of the curve and stability in European rates given the technical tailwinds of the ECB's QE purchases.

Mortgages (page 14): We are underweight mortgages relative to other high-quality spread sectors.

Structured Product (page 14): 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: Thought Leadership

In December, Chief Investment Strategist Robert Tipp published The Totally Mad World of Low Rates, which explores a world where rates are not just low, but ultra-low—even negative in many cases. It is a view where rates will stay ultra-low not only because inflation is low, but also because of the high levels of debt across the world's developed economies, which in turn have depressed growth and the equilibrium level of rates.

In addition, lead G-10 Economist Ellen Gaske released Prospects for the U.S. Economy Over the Long Run, which takes a unique path through the composition of U.S. growth in explaining why we think there are many reasons to be optimistic about future growth prospects in the U.S.

Video Outlooks

Our recently produced videos also explore current market trends and are available at *PGIMFixedIncome.com*. This quarter:

Mike Lillard, Head of Fixed Income, provides his market views surrounding the recent Fed interest-rate hike and where he sees value going forward.

John Vibert, Co-Head of Structured Product, explains the four themes influencing our asset allocation decisions in the sector in early 2016.

Erik Schiller, Head of Developed Market Interest Rates, joins Craig Dewling, Head of Multi-Sector and Liquidity, in a Q&A session about the positioning and outlook for our Global Liquidity Relative Value Strategy.

Additional Perspectives...

In "RMBS – After the Flood," John Vibert, Managing Director and Co-Head of Structured Product, explains why he still sees value in non-agency RMBS amidst tightening spreads and skeptical investors.

Coming Soon...

"A Hedge and a Hope," by Tom McCartan, FIA, Vice President of Liability-Driven Strategies, explaining the effect of credit migration on LDI strategies (part II in a series).

The New Bond Market Shuffle: One-step Back, Two-steps Forward

Confident but Cautious

The year of 2015 probably represented the kind of unproductive future many fear for fixed income: one of poor returns filled with anxiety about higher rates. In our view, 2015 was the typical "one-step back" year that will find its way between the equally numerous "two-step forward" years where fixed income delivers solidly positive returns. We believe this bumpy, but net-net productive path for fixed income will continue.

In this summary of our Outlook we'll review the basis for our optimism, which derives from a combination of our “low and range bound” rates hypothesis and our view that the spread sectors offer tremendous value.

Performance by Sector

While yields may not be at exactly eye-poppingly high levels, the fact of the matter is that, so far, returns during the low yield era haven't been bad, thanks to yield, curve roll down, and spread. With spreads at attractive levels and rates likely to be low and range bound, we expect the pattern observed in the following table to continue. Similar to the old Mark Twain quote, perhaps reports of the bond market's death have been grossly exaggerated.

	Total Return *(%, sorted by Q4 2015)*				
	Q4 2015	2015	2014	2013	2012
S&P 500 Index	7.0	1.4	13.7	32.3	16.0
European High Yield Bonds	1.8	1.3	5.1	9.1	24.8
Municipal Bonds	1.5	3.3	9.1	-2.6	6.8
EM Debt Hard Currency	1.3	1.2	7.4	-5.3	17.4
European IG Corporate Bonds	1.3	-0.6	8.4	2.4	13.6
EM Local (Hedged)	0.2	-2.2	3.2	-4.2	8.9
European Leveraged Loans	-0.1	3.6	2.1	9.0	10.8
Mortgage-Backed (Agency)	-0.1	1.5	6.2	-1.5	2.6
U.S. Aggregate	-0.6	0.6	6.0	-2.0	4.2
U.S. IG Corporate Bonds	-0.6	-0.7	7.5	-1.5	9.8
U.S. Treasuries	-0.9	0.8	5.1	-2.8	2.0
CMBS	-1.2	1.0	3.9	0.2	9.7
U.S. Leveraged Loans	-2.0	-0.4	2.1	6.2	9.4
U.S. High Yield Bonds	-2.2	-4.6	2.5	7.4	15.6

Sources: Barclays except EMD (J.P. Morgan), HY (Merrill Lynch), Senior Secured Loans (Credit Suisse). Performance is for representative indices as of December 31, 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.

Rates: the "Low and Range Bound" Hypothesis

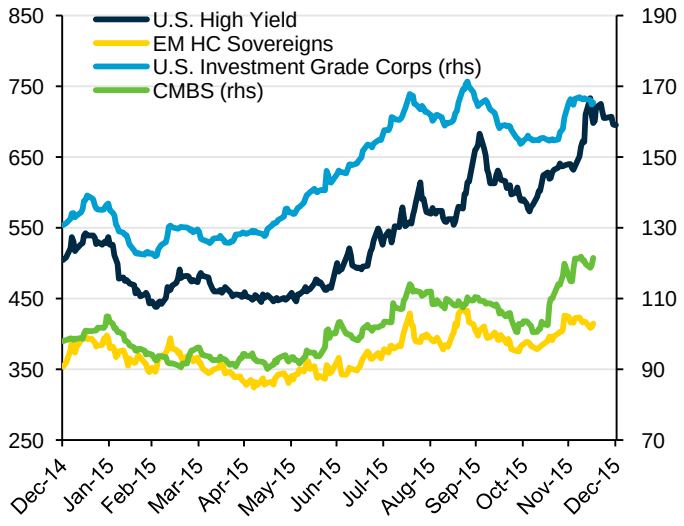
Forecasters have been stymied for decades as the decline in rates has proceeded through what could be seen as two stages. In Stage I, rates fell as central bankers regained control of inflation, and some of the structural factors that pushed rates up between 1960 and 1980—like the demographic impulse of the baby boom—waned. As rates fell, debt creation swelled around the world, bringing us to Stage II, where in our view the higher level of debt itself has probably pushed down the equilibrium level of rates, taking us from Stage I's low rates to Stage II's ultra-low rates (for more on this concept, see The Totally Mad World of Low Rates).

Whether we've correctly identified the cause or not, the “facts on the ground” are supportive of the notion that the current ultra-low level of rates does not appear to be unduly stimulative. The global economic backdrop is characterized by moderate growth and below target inflation, despite not only low rates, but a good dose of QE to boot. Furthermore, any central bank that has raised rates since the Great Financial Crisis has been forced to reverse course. Of course, there are and will be variations country by country, but overall, we expect long-term G-3 rates—including those in the U.S.—to remain below their highs of 2015 for some time to come, and that bodes well for fixed income products, via yield and curve roll down alone, to significantly outperform cash over the intermediate to long run.

Spread Sectors' Pros and Cons: What's the Basis for Our Optimism?

On the con side, leverage in the world's economies is elevated, increasing downside risks. Furthermore, sub-sectors of the spread markets as well as a range of countries are facing fundamental challenges—especially those that have exposure to the so-called extraction industries. But sectors, issuers, and countries away from the credit “hot spots” also saw their spreads widen notably in sympathy over the second half of 2015, leaving spreads at a substantial premium to fair value in our view.

The Broad Widening of Spreads in Late 2015 (bps)



Source: Bloomberg as of December 2015.

Policy Should Support Risk Appetite in 2016

Policy makers were busy in 2015. While the issues, policy approaches, and measures varied widely by region and country, a common undercurrent has been the intent to promote growth, keep markets calm, and get inflation up to target. We believe this will continue through 2016 and should generally be supportive of risk appetite and, therefore, supportive of the spread sectors.

U.S.: The Fed is the big driver here. While it is keen to raise rates, it has nonetheless made it clear that it does not want to see an excessive tightening of financial conditions that could precipitate an economic slowdown. So, although it is raising rates, it seems fairly clear that it will be cautious in the execution.

Europe: In addition to being aggressively accommodative in its monetary policy, the ECB has been consistent in drawing red lines to ward off bad behavior—forcing the closure of the banks in Greece is one recent example. This combination of monetary support and enforcement should be generally supportive of European growth and peripheral country spreads as the ECB actions boost liquidity while representing a prominent counterbalance to the political shift in European peripheral countries towards less conservative policies.

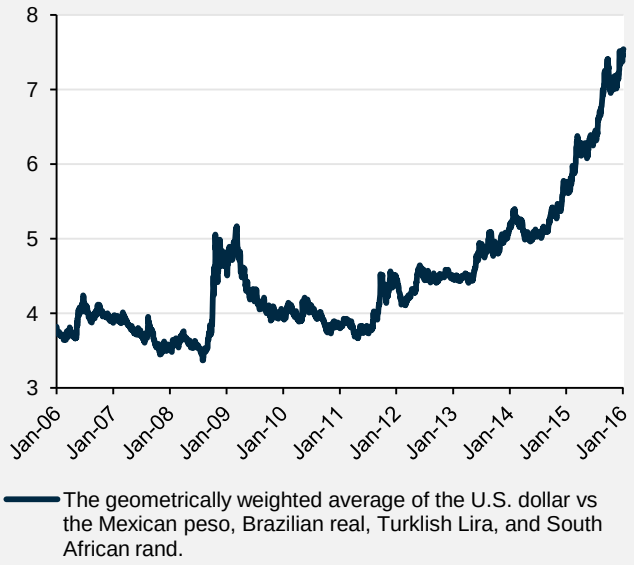
Japan: While the impact of Abenomics may be becoming more subtle, the Bank of Japan has nonetheless continued to increase accommodation, albeit in more incremental steps.

China: Policy makers will continue to aggressively fight the slowdown. While only time will tell whether the rapid rate of debt creation is sowing seeds of trouble down the road, efforts to reduce downside economic risk are likely to continue in 2016.

Late Innings in the Dollar Bull Market

One thing worth watching in 2016 will be the course of the U.S. dollar. With the U.S. expansion enabling Fed lift-off as other DM and EM economies lagged, or even stalled, the dollar had another strong year, especially versus EM currencies. But the rally slowed versus DM currencies, raising the question of whether the point of maximum policy divergence between the U.S. and other DM countries was reaching its maximum and possibly signaling an end to the dollar rally. While the struggles of EM countries—especially those reliant on commodity exports—look set to continue to varying degrees, EM currencies have depreciated a great deal, raising the question: weak fundamentals notwithstanding, is the price right for a turn? At this point, our view is for continued dollar strength over the near to intermediate term. But we will continue to watch carefully as the rally could well be in its late innings, or even near a turning point (*continued in next column*).

How Much Further Will the Dollar Bull Run?



Source: Bloomberg as of January 2016.

The Fed's Cleared the Joint; 2016 Should Echo 2014's Bond Market Rebound

With 2016 underway, we can't help but highlight the parallels with the end of 2013 and the Fed induced "taper tantrum." Rates have risen, spreads have widened, and retail investors have been aggressive sellers of their mutual fund shares. The result: fixed income valuations, in our view, are quite favorable, with rates at the top of their recent ranges and spreads at multi-year wides in many cases. There are risks on the horizon, but the overall Outlook, as described in the following economics section, is generally one of continued modest growth, creating what could be a very productive "two-steps forward" Outlook for bonds in 2016.

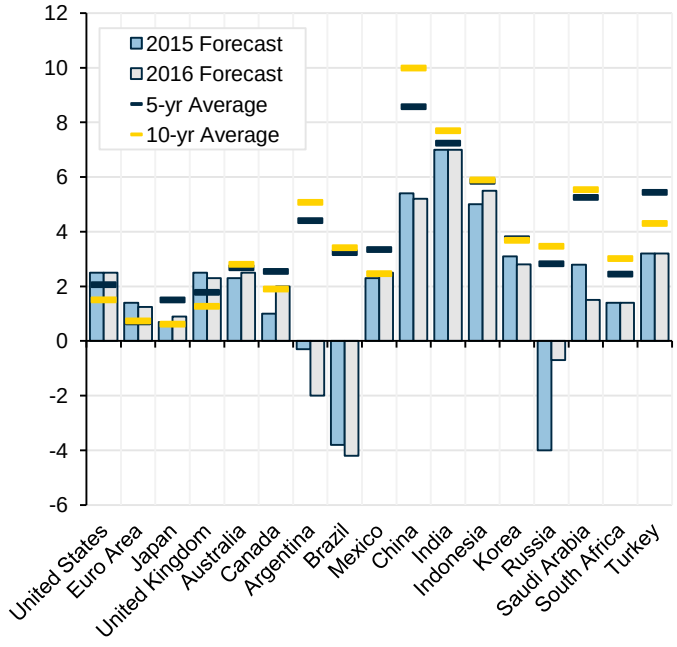
The Bottom Line: A bumpy, but productive/bright future for bonds as fears of the Fed are overdone, leaving the bond market well positioned for 2016. Rates are likely to remain low and range bound, while the spread sectors offer an array of attractive valuations. As a result, thanks to yield and curve roll down, as well as wide spreads, fixed income should surprise on the upside in 2016.

The View After Lift-off

With 2016 underway, we anticipate that many of the global themes prevalent last year will continue to play out in the coming quarters. U.S. economic growth is expected again to outperform its G3 peers in level terms, growing once more at a 2.5% pace in 2016, led by U.S. consumers and further labor market improvements early in the year. We anticipate that the euro area, though, will continue to struggle to rebalance, with GDP growth in the region slowing slightly to a 1.2% pace in 2016, as boosts from ECB stimulus and lower energy prices wane, while governments and portions of the private sector continue to delever. Policymakers in Japan, meanwhile, have bought time for their economy to recover further from a 2014 tax hike and for private sector reforms undertaken over the past several years of Abenomics to slowly gain more traction. Absent unforeseen external shocks, economic growth in Japan is expected to accelerate to a 0.9% pace.

But concerns over the potential for turbulence emanating from China have also carried into the New Year. Chinese officials have let up on the fiscal brakes imposed on local governments that had induced a rapid slowdown earlier in 2015 and are now using monetary and exchange rate policies in an attempt to engineer more stability—at least in the near-term. Simultaneously, though, they are forging ahead with a number of market-based reforms—a delicate balancing act against the backdrop of an expected multi-year structural slowdown of the Chinese economy.

GDP Growth Forecasts and Historical Averages (% Annualized)



Source: Haver Analytics and PGIM Fixed Income as of December 2015.

One Gap Fills, Another Opens Up

A defining development in 2015 was the continuation of the commodity price slide that had begun in 2014, as growth in global commodity production capacity and output overwhelmed what again turned out to be weaker global growth conditions than consensus forecasts projected. The excess capacity now exposed in the commodity sector is but one of a series of output gaps that has opened up over the last eight years, e.g. the U.S. subprime crisis in 2007-2008, followed by the euro area peripheral debt crisis in 2012. Even as economies continue to adjust to these previous crises, structural adjustments are now also being required of commodity producers and exporters; the ongoing fallout from the collapse of commodity prices is expected to be a dominant theme in 2016.

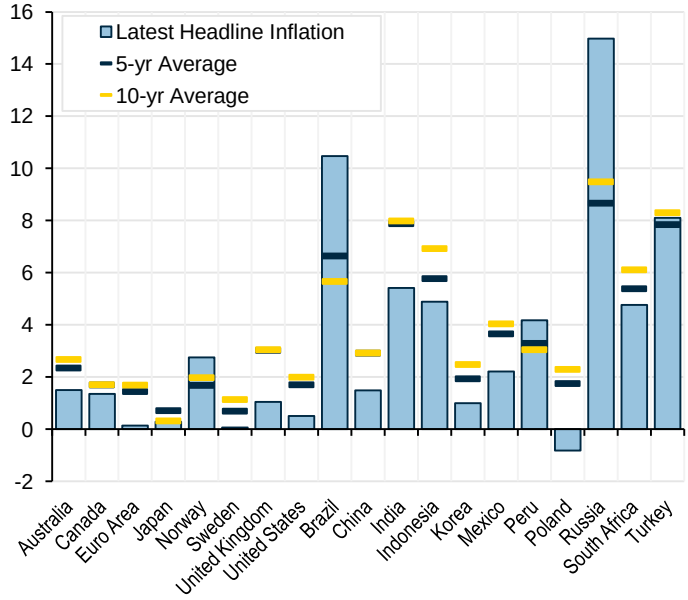
One factor drawing out adjustments to the lower commodity price environment is the fact that cutbacks in capacity and output in this sector so far have been slow. While new mining investment has been curtailed sharply over the last year—taking related equipment manufacturing activity down with it—mining output has generally continued at a surprisingly robust pace. Many commodity producers have doubled-down on production, technological improvements and geopolitical developments have effectively brought yet more supply, while newly-built production capacity, long in the making, has also continued to come online. Increased supply and lower commodity prices have also been met by a relatively muted demand response so far, as households and businesses that are heavy commodity users have been cautious and slow to take advantage. Meanwhile, government finances in many commodity-producing regions and countries are being challenged, with consequent fiscal adjustments also likely to be required over time. The speed with which households and businesses adjust and the domestic economies of commodity-producing countries rotate to alternative sources of growth is expected to be an ongoing issue in coming quarters.

Global Inflation Generally to Remain Capped

A by-product of the rolling series of output gaps since the 2007/2008 financial crisis continues to be relatively contained global inflation pressures, despite aggressively stimulative policies of the major central banks. The collapse in energy prices over the last year and a half has pushed headline inflation well below central banks' targets in all but a handful of EM countries. But core inflation, too, has remained broadly capped, even in many countries and regions with depreciating currencies over this period—including the euro area and surrounding countries, as well as many of the commodity exporters. With the notable exceptions of Brazil, Turkey, and Russia, the effects of weak domestic demand and lower commodity prices have kept inflation pressures generally in check to date.

The path of commodity prices from here is expected to be pivotal, but for now, their additional leg down in 4Q15 suggests generally low monthly headline numbers over the near term. Our base case, however, assumes the strongest inflation down-draft from falling oil prices is likely behind us. Oil prices fell 50% in the second half of 2014, followed by a 16% decline in the first three quarters of 2015 and a further 18% drop in 4Q15. Thus, going forward in 2016, the sharp decline that occurred in 2H14 will fall out of year-over-year comparisons, making way for year-over-year headline inflation rates to reverse course and begin rising moderately again. But given oil's further price decline in 4Q15, the pace of headline inflation's re-acceleration at this point looks likely to be shallower than many analysts previously expected. And central bankers are likely watching carefully for any signs that a prolonged undershoot of headline inflation doesn't become self-perpetuating by becoming embedded in inflation expectations.

The Middling Inflation Picture (% YoY)



Source: Haver Analytics as of December 2015.

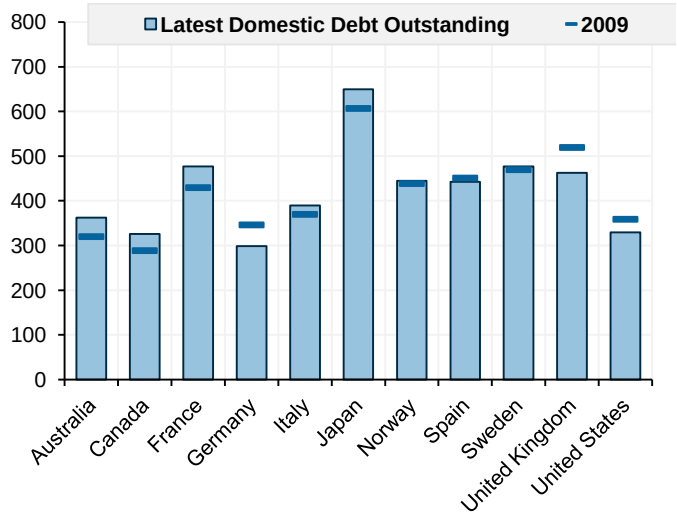
Fed Finally Lifts off; ECB and BoJ on Cruise Control, for Now

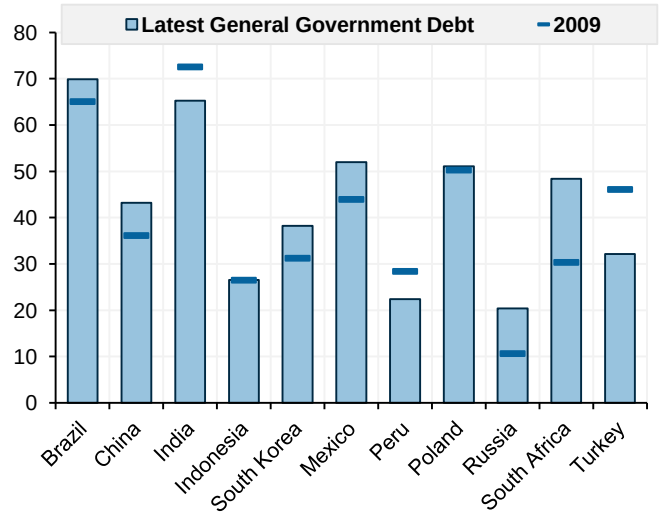
The magnitude of G3 central bank policy changes has become notably more incremental over the past year, despite bouts of high expectations for more aggressive action. The Federal Reserve finally lifted policy rates by 25 bps in December 2015—a major shift in policy course—but the increase was far short of the 75-100 bp of hikes Fed officials had expected to implement over the course of 2015, according to their median projections at the start of the year. In December 2015, the ECB tweaked the QE program it had announced back in January of that year and lowered its already-negative policy rate another 10 bps. But the heavy-lifting of adopting a negative policy rate and signaling a likely QE initiative had been done in 2014. Likewise for the BoJ, as it spurned market participants' repeated calls for more stimulus, choosing instead to fine-tune its existing, already-large QQE purchase program.

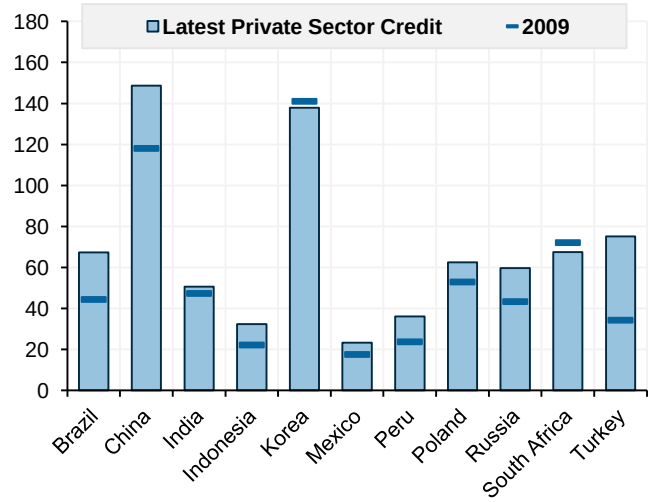
At this point, there is a growing sense that across a number of countries, monetary policy's ability to cushion downside risks may be bumping up against limits. Given already elevated debt levels, there is now reduced scope or desire to further stimulate credit-sensitive sectors in many countries. Indeed, it's a constraint now felt in commodity-producing countries where housing markets and household debt levels became elevated during the boom phase of the commodity cycle. Meanwhile, the net-export benefits of a lower currency have not materialized as was hoped, and the wealth effects of higher asset prices in stimulating increased spending have been less than in previous cycles. Fiscal policies have recently turned marginally more stimulative in a number of countries as governments have eased up on previous consolidation plans, but nonetheless are also limited by already-elevated sovereign debt levels.

Past policy easings by other central banks likely helped support the global economy enough for the Fed finally to lift-off in December. But limited scope for additional easing—both in the U.S. and globally should it become necessary—is expected to make the Fed much more cautious towards additional rate hikes in the coming year. Our base case assumes three additional 25 bp hikes in 2016, but with risks skewed to the downside.

A Still Heavily Indebted World (% of GDP)







Source: Haver Analytics and PGIM Fixed Income as of December 2015.

Risks to the Outlook Ahead

Risks to the global growth outlook appear to be somewhat skewed to the downside at this point. Upside surprises are possible if, for example, those benefiting from lower commodity prices begin to take fuller advantage of the current abundant supply; fiscal policies were to become marginally more stimulative as those governments still in consolidation mode let up further on the brakes; or if monetary stimulus already in place across the G3 possibly begins to take greater effect, albeit with long lags. And while the epoch wave of migration into Europe currently underway is likely to challenge European governments' resources for now, longer term, it could prove to be a significant boost to the region's economic growth.

But the risk of another meaningful decline in commodity prices remains a source of concern for the producers. And given significant structural adjustments still needed across so much of the globe, there is perhaps greater scope for policy mistakes, particularly in the face of political pressures to cushion the pain from these adjustments. After several years of austerity, the political center of gravity in Europe, for example, is shifting left. Policy makers are attempting to engineer soft landings, but in many cases at the expense or risk of increasing imbalances, including already-high debt levels.

The more limited scope for additional policy easing by the G3 is itself a downside risk to the global economy. Our base case for the coming year, however, is for heightened caution on the part of the Fed and other major policymakers around the globe and for an ongoing gradual pace of structural adjustments that leave global aggregate growth on par with recent trends.

U.S. and European Corporate Bonds

U.S. corporate bonds delivered a return of -0.58% in Q4 and -0.68% for 2015, reflecting uncertainty regarding slower global economic growth, the Federal Reserve's first rate hiking cycle in nearly 10 years, record issuance, and steep decline in energy and commodity prices. Despite nominal tightening in Q4, corporate bond spreads over similar-maturity U.S. Treasuries rose 34 bps during the year to close at 165 bps. For the 12 months, corporates delivered an excess return of -161 bps to U.S. Treasuries.

European corporate bonds performed well in Q4 with a return of +1.30%, lifting the year-to-date return to -0.56%. Despite the launch of the European Central Bank's asset-purchase program, spreads rose 46 bps on the year, primarily due to weakening global economic growth and broad macro risk-off themes.

	Total Return		Spread Change		OAS
	Q4	2015	Q4	2015	12/31/15
U.S. Corporate	-0.58%	-0.68%	-4 bps	+34 bps	165 bps
European Corporate	+1.30%	-0.56%	-14 bps	+46 bps	134 bps

Represents data for the Barclays U.S. Corporate Bond Index and Barclays European Corporate Bond Index (unhedged). Sources: Barclays as of December 31, 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

In the U.S., intermediate-term issuers delivered positive results while longer-maturity debt lagged as volatility rose. Overall, credit fundamentals and earnings remained healthy (ex-energy and metals/mining) for this stage of the credit cycle despite increasing leverage from industrial companies issuing debt to finance mergers and acquisitions, share buybacks, and dividend payments. Acquisition-related financing accounted for more than one-third of 2015's record issuance of nearly $1.2 trillion. Based on the volume of announced deals, M&A supply will likely continue at a brisk pace in the new year. Although volume strained the market at times, technicals were generally strong with issuance well absorbed by both U.S. and non-U.S. investors.

Financial issuers outperformed industrials by more than three percentage points for the year. Financials remained supported by their relative immunity to event risk and their vastly improved credit profiles to meet government capital and liquidity requirements. Financial spreads even held in well following the government's much anticipated announcement in Q4 of higher minimum capital buffer or "total loss absorbing capacity" (TLAC) requirements, which resulted in Standard & Poor's downgrading several banks.

Across other sectors, oil and metals/mining were among the worst performers of the year, while consumer-related sectors generally benefited from a pick-up in U.S. economic growth.

At current levels, we believe corporate bonds remain attractive given positive U.S. growth prospects and ongoing quantitative easing in other developed markets, which should draw demand for the relatively higher yields of U.S. corporate bonds. Assurances from the Fed that rate increases will be modest also provide support.

We continue to favor U.S. financial issues, primarily money center banks. Financials no longer offer a spread advantage over industrial issues, but we believe they are still poised to outperform other sectors in the coming year. Within industrials, we favor auto, chemical, and select pharmaceutical issues. We are emphasizing U.S. "centric" issuers over multi-national and export-driven companies that 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 underweight the energy sector, we are scanning for opportunities in light of the sector's wider spread levels. We continue to favor BBB-rated bonds in shorter maturities and, on a tactical basis, longer maturities given the steep credit curve and 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 a safe haven from event risk.

In the coming year, we look for global headwinds—sluggish global economic growth, trajectory of the Fed's rate hikes, and geopolitical risks—to generate bouts of volatility. Individual security selection remains key, especially given a potential uptick in rating downgrades and defaults, particularly for oil and commodity-related issuers.

European Corporate Bonds

As in the U.S., slower global economic growth, particularly in China, and record new issuance created bouts of volatility throughout the year, pressuring European corporate bond spreads. Spreads in both low and high-beta European sectors widened for the 12 months with the metals/mining and energy-related sectors singled out for punishment. European corporate spreads ended the year at 134 bps.

At current levels we believe euro corporate spreads are attractive in light of reasonably strong fundamentals and corporate management that remains cautious, resulting in limited M&A risk across most industries. The European Central Bank's ongoing quantitative easing program remains a key support, with additional maneuvering possible in 2016. The bottoming out of most European economies, signs of improving regional growth, and lower energy prices and FX also provide a solid backdrop.

New issuance is expected to remain robust in the coming quarter with "reverse yankee" companies continuing to issue in the lower-yielding European markets. Despite the volume, technicals have been strong with the primary market tightening into the secondary market in Q4. In fact, European technicals currently appear stronger than in the U.S.

Near term, our strategy remains relatively unchanged. We are looking for opportunities to invest in issuers we believe are oversold, as well as in new issues with attractive concessions. We continue to focus on UK and Northern European issuers over peripheral country debt. We favor euro area 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 have increased exposure to European issuers and now hold an overweight versus portfolio benchmarks. In the U.S., we continue to favor financials and insurance companies over industrials. In Europe, we favor 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.

In both the U.S. and Europe, we believe spreads have room to tighten but look for volatility to remain high. Key risks in 2016 include slowing global growth, heavy issuance, tighter liquidity, geopolitical risk, and, in the U.S., event risk. European politics/monetary policy and peripheral country risks may also stoke volatility.

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

Global Leveraged Finance

While further commodity-related volatility kept the lower-quality segment of the U.S. high yield market under strain as 2015 concluded, more stable market segments—such as European high yield—also encountered turbulence amid news about redemptions at a few distress-oriented funds. When looking ahead, we acknowledge the strain among commodity-related credits and within the lower-quality segments of the U.S. market, yet our optimistic outlook is based on the broader spread widening that created opportunities in the European markets and pushed U.S. yields to a four-year high in Q4. In general, we believe the recent yield levels more than compensate for ex-energy fundamentals that remain relatively sound.

	Total Return		Spread Change		OAS
	Q4	2015	Q4	2015	12/31/15
U.S. High Yield	-2.17%	-4.64%	+33 bps	+191 bps	+695 bps
European High Yield	+1.50%	+1.82%	-21 bps	+103 bps	+520 bps
U.S. Leveraged Loans	-1.96%	-0.38%	+61 bps	+85 bps	L+643 bps
European Leveraged Loans	-0.07%	+3.64%	+31 bps	+27 bps	L+568 bps

Sources: BofA Merrill Lynch and Credit Suisse as of December 31, 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

Looking ahead in the U.S. leveraged finance market, one approach is to look what changed towards the end of 2015 and what remained relatively steady. In terms of what changed, the market has a couple of notable events behind it following the Fed's highly anticipated lift-off and the significant widening in spreads as retail investors reacted to negative headlines.

While the Fed's messaging was not overtly dovish and multiple rate hikes are forecast in 2016, lift-off provided the market with some clarity and Fed Chair Yellen has repeatedly commented that the committee will not risk derailing the economic recovery through tighter monetary policy.

The recent spread widening cuts two ways. It certainly creates opportunity among solid credits or issues that have been indiscriminately sold alongside weaker names. But among those weaker issues, further market volatility—should it occur—could create a cyclical effect whereby these credits eventually encounter a financing strain. The latter scenario is one reason we maintain a more cautious

Sources of data on this page: European corporate bonds, Barclays; all high yield, BofA Merrill Lynch, all leveraged loans, Credit Suisse

stance toward the "CCC" market segments, or below, than otherwise would be the case.

Although the lower-quality segments, which comprise about 15% of the overall market, also served as a focal point for the liquidity concerns that gripped the market following the redemption headlines, smaller issues and ETFs trading at a discount to their net asset values also reflected some of the liquidity strains, which tend to worsen toward quarter and year-end periods. Overall, buying interest across the high-quality tiers of the market remained relatively consistent throughout the volatility, and we expect that to continue in 2016 as well.

However, deterioration in liquidity conditions across the market could create some opportunities as well. Portfolios held relatively high cash balances as 2015 came to a close, and if those balances are drawn down on additional redemption requests, some attractive short-term issues could emerge as portfolios sell more liquid assets to meet those redemptions.

In terms of market trends that remained in place, the energy sector was a familiar underperformer in Q4 as crude oil prices fell to a seven-year low. Yet, away from commodity-related credits, fundamentals in the other sectors appear relatively steady. The U.S. consumer is spending and we expect U.S. GDP growth to be above 2% in 2016. Leverage and coverage statistics, excluding commodities, have deteriorated slightly, but remain stable overall. That said, there were some pockets of weakness among suppliers to commodity-related companies, retailers that hit a soft patch amid the strong dollar and a stretch of warm weather across much of the U.S., and select healthcare and pharmaceutical names.

Despite outperforming bonds at a time that brought the first increase in the Fed funds in nearly 10 years, the U.S. leveraged loan market notched 23 weeks of consecutive outflows in 2015 with the total of $20.3 billion surpassing the $13.4 billion in outflows from the U.S. high yield market. Leveraged loans appeared attractive on a relative value basis following the recent volatility, but market technicals deteriorated during the year given the outflows and the moderating pace of CLO formation.

The loan market's $318 billion in supply also surpassed the $293 billion in high yield supply, and the primary market activity in both markets fell short of 2014 totals of $467 billion and $348 billion, respectively.

European High Yield and Leveraged Loans

While the European leveraged finance market encountered some volatility as 2015 concluded, both the European loan and high yield markets outperformed their U.S. counterparts with both posting positive total returns. Indeed, European loans were among the best performing asset classes during the year.

The contrast between the U.S. and European market performance is due to a number of factors, foremost being the limited exposure to commodity sectors in Europe. As a result, the amount of stressed issuers is lower in both the bond and loan markets. Additionally, loan performance proved particularly resilient given its very limited retail investor base, unlike the U.S. loan market, and, therefore, has not suffered from a string of retail outflows. Meanwhile, CLO arbitrage and formation activity has remained stable.

In terms of additional differences between the European and the U.S. high yield markets, while the Eurozone economy is certainly sluggish, it is in fact recovering, albeit from a low base. The Eurozone is growing its QE program, which is already having some meaningful impacts, including the collapse in the euro exchange rate which has made European exports more competitive. Indeed, we generally observed solid momentum in Q2 and Q3 earnings across our European portfolio holdings.

The underperformance of the high yield market at the end of the year was due in part to certain emerging market corporates, such as OI and Petrobras, that issue in euros and comprise a notable portion of the major European indices.

In the general selloff over the second half of the year, European high yield spreads widened in sympathy with the U.S. high yield and EM debt markets, while new issue spreads also started to arrive at wider concessions. This created opportunities in the second half of 2015, and we expect these opportunities to remain in place this year. Indeed, even in European leveraged loans, where pricing is often sticky, we have seen improved economics.

We have also witnessed an increase in volatility on negative news stories. This has happened in certain European single-B names, but more recently has come in the form of U.S. domiciled issuers, such as Chemours and Valeant, which both issue in the European and the U.S. markets.

Given our constructive European economic outlook, which we believe is in an earlier stage of the cycle relative to the U.S., we think defaults will be lower than in the U.S., especially due to less energy and commodity exposure. That said, we anticipate some European restructuring, especially among retailers where certain issuers may start to run out of liquidity and strategic options.

In terms of spreads, Europe is now tight to the U.S. in both the loans and bonds, which may lead many to feel the current opportunities lie in the U.S. markets. However, once the distressed sectors and issuers are stripped out, European spreads appear to be at similar levels, or wider in some cases. Combine this constructive backdrop with what should be less default and restructuring-related volatility, and we believe both European loans and bonds will have another positive year in 2016 when we expect some spread tightening from current levels if we see concurrent improvement in the U.S. market.

OUTLOOK: Attractive. We expect spreads to recover and tighten as current fundamentals, ex-commodities, are better than current spreads indicate. There is a risk that recent market conditions for weaker credits becomes self-fulfilling, i.e. bond prices begin to affect credit fundamentals. Hence, our less optimistic view for CCCs. We are positive on European high yield given the fundamental benefits of a weaker euro, lower fuel costs, less exposure to commodities, and an earlier stage in the economic cycle.

Emerging Markets Debt

Emerging market returns were flat to slightly positive in Q4. Hard currency sovereigns were the best performers with a +1.25% return, while hedged local bonds and EM currencies returned +0.17% and -0.14% respectively. Spreads on the hard currency sovereign index were 19 bps tighter during the quarter and corporate spreads and local yields were roughly flat.

The year-to-date returns were more mixed. Hard currency sovereign bonds returned 1.18%, although spreads widened 61 bps to end the year at 415 bps over U.S. Treasuries. Hedged local bonds returned -2.24%, while currencies took the brunt of the macroeconomic adjustment with returns of -7.61%. Local yields ended the year 64 bps higher at 7.13%.

	Total Return		Spread/yield Change		OAS/Yield
	Q4	2015	Q4	2015	12/31/15
EM Hard Currency	+1.25%	1.18%	-19 bps	+61 bps	+415 bps
EM Local Currency (hedged)	+0.17%	-2.24%	+5 bps	+64 bps	7.13%
EM FX	-0.14%	-7.61%	+3 bps	-55 bps	4.97%
EM Corporates	+0.45%	+1.30%	-14 bps	+63 bps	+418 bps

Source: J.P. Morgan as of December 31, 2015. Past performance is not a guarantee or reliable indicator of results. An investment cannot be made directly in an index.

EM Hard Currency

Returns across countries were widely dispersed in 2015, with the idiosyncratic impacts of politics, commodity sensitivity, and regional economies substantially impacting performance. Africa (-5.14%) and Latin America (-2.00%) were the worst performing regions due to higher levels of commodity sensitivity and political turmoil in key countries, such as Brazil. Conversely, Asia (+1.11%) and Europe (+7.44%) benefited from higher concentrations of commodity importers and Russia's rebound after its 2014 selloff.

Below investment-grade countries outperformed more highly-rated countries on average. The highest-returning countries on the year were low-rated names where market friendly restructurings took place (Ukraine +41.75%) or are expected in the future (Argentina +26.65%). Russia (+21.11%) also rebounded strongly from its sanction-related selloff after it became clear that the willingness and ability to pay on its bonds remained strong, and Kazakhstan (+6.89%) benefited from a buyback of quasi-sovereign bonds. The worst performing countries were generally oil/commodity exporters, such as Zambia (-19.50%), Colombia (-6.97%), Gabon (-10.64%), and Iraq (-13.56%). Brazil (-13.39%) also performed poorly as political scandals and fiscal laxity led to multiple downgrades and a relegation to the high yield universe. Less surprising, shorter-maturity bonds outperformed longer-term bonds as spreads widened across the market.

Going forward, the environment remains opportune for country and asset selection. We will remain cautious with commodity exporters until we see a definitive turn in the commodity cycle. We favor overweight positions in countries with stable-to-improving credit trajectories, such as Hungary, Indonesia, and Mexico as well as Argentina, where we believe the newly-elected Macri government will usher in more market-friendly policies. Strategic underweight positions in deteriorating credits (including Brazil, South Africa, Colombia, and Malaysia) should also

provide good opportunities to generate alpha. Careful issue selection will be important: overweights in the 4-6 year parts of the yield curves should benefit from rolling down steep yield curves, while lower-quality overweights in 1-3 year paper should add incremental carry. Long maturity holdings in improving country credits will be used to keep portfolios roughly matched to their benchmark durations.

EM Local Currency Bonds

Returns on EM hedged local bonds also varied, although the dispersion was less than what was observed in the hard currency space. Deteriorating credit stories dominated the lower returners—these economies were typically negatively impacted by the commodity price declines and poor currency performance, which prevented central banks from implementing countercyclical monetary policies. This category includes Colombia (-2.67%), Peru (-11.13%), Brazil (-7.89%), and South Africa (-9.06%). Despite being a commodity importer, Turkey (-10.45%) also underperformed as concerns over unorthodox central bank policy and independence drove yields higher. The top performers were generally higher-quality, low-yielding countries, such as Malaysia, Mexico, Romania, and Thailand, but returns in these countries were a relatively paltry 0-2%. Russia (+16.40%) was the top performer on its aforementioned rebound.

Going forward, we continue to find opportunities to be long duration in select countries and curves. The steepness of the local Mexican curve implies many more hikes than we believe will actually occur, and, as a result, we like the 8-year and 15-year segments of the curve. In Indonesia, we prefer the 5-year part of the curve, which we think will benefit from an upcoming easing cycle by Bank Indonesia and the concurrent fall in local inflation. Our overall positioning in local bonds remains limited, however, as we remain cautious on emerging market currencies. Hedging the currency risk from the local bond positions virtually eliminates the yield and carry advantage of most local bond positions.

EM Currencies

U.S. dollar strength was the principal story for EM currencies in 2015, with negative returns across all regions. Underweights and shorts in EM currencies were a major source of alpha for our portfolios. The largest declines came in oil exporters' currencies, such as the Colombian peso (-21.95%) and Malaysian ringgit (-16.12%), and in countries where credit deterioration resulted in downgrades, namely the Brazilian real (-24.50%) and South African rand (-20.41%). Even countries with reasonably strong underlying fundamentals experienced currency weakness; the Mexican peso (-12.28%) suffered from its role as a liquid hedging vehicle for other less liquid currencies. Eastern European currencies suffered from the euro's weakness, while Asian currencies declined amid the depreciation in the Chinese yuan.

Going forward, we continue to believe that EM currencies will face headwinds from anemic GDP growth, slower global trade, and soggy commodity markets. The selloff in currencies, which began in 2011, has clearly made currency valuations more attractive, but it is difficult to see a catalyst that will reverse the negative trend in the near term. Thus, we will continue to position the portfolios with a net long in the U.S. dollar until we see a reversal of these trends, focusing our underweights and shorts in deteriorating credit stories, such as Brazil, and overvalued currencies, including the Peruvian sol.

OUTLOOK: Selective. Positions will be concentrated in hard currency bonds from commodity importers and select exporters, including as Argentina, Russia, and Kazakhstan. We generally prefer sovereigns to corporates, although certain of the latter are becoming increasingly attractive. We maintain secondary, long-duration positions in local bonds, the yield of which are near decade highs. We maintain selective shorts in EMFX.

Municipal Bonds

AAA-rated municipal bonds outperformed U.S. Treasuries across the curve with the 30-year Municipal/Treasury yield ratio dropping to 94% from 106% at the start of Q4. Lower yields led to positive total returns in Q4 for both high grade (+1.50%) and high yield (+1.78%) municipals. Total returns for 2015 were +3.30% and +1.81% for high grade and high yield, respectively. High yield returns continue to be influenced by Puerto Rico credits, which returned -1.43% in Q4 and -12.01% for the year. Long taxable municipals returned +1.40% in Q4 and -0.23% in 2015, outperforming the long corporate index.

Issuance of only $80 billion in Q4 was well below the expectations of many market participants. Full year gross supply of $398 billion represented a 17% increase versus the prior year, with refunding volume comprising over 50% of the total. Retail investors appear to have grown more comfortable with the idea that the path to higher rates will be gradual following the Fed's first hike. Weekly flows into municipal funds have been positive since the end of Q3, resulting in Q4 net inflows in excess of $8 billion and full year net inflows in excess of $13 billion.

Sources of data on this page: Emerging markets debt, J.P. Morgan. Municipal bond supply, J.P. Morgan; Municipal returns, Barclays.

The volatility in Puerto Rico continued in Q4 as Governor Alejandro Garcia Padilla and other parties increased their Congressional lobbying efforts to gain access to Chapter 9 bankruptcy protection. While several Congressional hearings in Q4 did not result in Chapter 9 access for the Commonwealth, it appears that Puerto Rico's fiscal crises have been elevated among various players in Washington, DC. The leader of the House stated that hearings regarding Puerto Rico's fiscal crises will occur when Congress reconvenes, with the intention of providing a "responsible solution" to the fiscal crises by end of Q1. The Puerto Rico Electric Power Authority (PREPA) and the bond insurers reached agreement on restructuring terms late in the quarter; this follows the restructuring support agreement (RSA) reached between PREPA and other creditors in Q3 and will allow PREPA to move forward with a debt restructuring. While the RSA is still subject to legislative approval, this is positive news for PREPA bondholders. Puerto Rico volatility will continue in 2016, with focus on any payment defaults and Congressional action.

The major credit stories that have dominated the news flow this past year will continue in 2016 as long-term solutions to problems in Illinois, Chicago, and New Jersey remain elusive. The lack of FY2016 budgets in Illinois and Pennsylvania are important reminders that political will, or lack thereof, is difficult to analyze and can certainly have an impact on ratings and spreads.

We continue to believe that these credit stories do not pose a systemic risk to the broader municipal market. Strong technical factors combined with stable-to-lower rates should contribute to the continuation of positive mutual fund flows. While municipal/Treasury yield ratios appear rich against recent averages, taxable equivalent yields remain attractive for investors who can benefit from the tax-exempt nature of the asset class. Given that little has changed regarding unfunded pension liabilities, this issue remains the biggest credit risk for certain states and localities.

Looking forward, we expect taxable municipals to perform in line with corporate bonds with the potential to outperform if supply pressures weigh on corporate bond spreads.

OUTLOOK: Positive based on supportive technical environment and attractive taxable equivalent yields.

Global Rates

Third-quarter turbulence in global markets gave way to fourth-quarter calm and opened the door for the Federal Reserve to raise benchmark interest rates for the first time in nearly 10 years. The better risk environment combined with continued strength in U.S. economic data allowed for considerable divergence in developed market interest rates in Q4.

U.S. yields rose considerably in 2-10 year maturities (45 bps and 20 bps, respectively), while 30-year yields were relatively unchanged as they hovered around 3.00%. Interest rates in the United Kingdom and Australia also moved slightly higher through Q4, with 10-year yields higher by 15 bps in both of those countries. The most buoyant rates were those in the low-yielding countries benefiting from central bank QE, as bund rates remained low and the yield curve steepened slightly, while Japanese rates fell modestly after the BoJ extended the target maturity of its QQE program.

U.S. swap spreads finished the quarter 2 bps tighter after they tightened significantly in November. The moderation in corporate issuance and the corresponding reduction in corporate swapping activity in December helped swap spreads move off the lows as the year ended.

Looking ahead, we see several opportunities in the developed interest rate markets in 2016. The recent flattening of the U.S. yield curve fits with the process of Fed tightening, and we expect a bit more flattening of the yield curve as Q1 continues. This should also help keep long-maturity rates low and range bound. Inflation protected securities (TIPS) should outperform nominal Treasuries as inflation moves higher due to basing effects throughout Q1. Implied volatility on forward rates should decline as the correlation of short-term rate movements with long-term rates increases and dampens the realized volatility on forward rates. While swap spreads are at risk of moving further into negative territory in Q1 given the expectation of robust corporate issuance, spreads should move wider through the remainder of 2016 given the dynamics of government issuance and Treasury collateral demands.

Japanese government bonds are at risk of higher yields as the maximum impact of QQE is built into the term structure, and marginally better growth and inflation data could potentially come to the fore. European rates are likely to remain low and range bound as the ECB's purchases will likely exceed net supply through 2016.

OUTLOOK: Opportunistic. We expect the term risk premium in the U.S. Treasuries market to decline and TIPS to outperform nominal Treasuries. We see a risk for higher JGB yields in the belly of the curve as the BoJ's QQE program may have reached its maximum impact. European rates will likely remain stable given the technical tailwinds of the ECB's QE purchases.

Sources of data on this page: Global Rates, Bloomberg.

Mortgages

Agency mortgage-backed securities outperformed U.S. Treasuries in Q4 with a total return of -0.10% and an excess return of +61 bps. For 2015, the agency MBS sector returned a positive 1.51% with an excess return of -5 bps. Despite periods of volatility, MBS spreads over U.S Treasuries tightened in Q4 and ended the year close to unchanged relative to beginning of year levels.

During the quarter, the MBS sector benefited from strong demand including outright buying from banks and non-U.S. investors. Overall healthy demand levels and constrained origination helped to shrink broker/dealer inventories in Q4 back toward their lows for 2015. A new consumer disclosure regulation was implemented in Q4, which caused logjams with originators lengthening closing timelines and dampening mortgage activity. MBS prepayment speeds continued to slow as primary mortgage rates remained in a fairly narrow range. Aggregate prepayment speeds declined to the lowest levels since mid-2014 and are expected to remain muted near term due to seasonal factors.

The Fed's MBS reinvestment program continued in Q4 at roughly $24 billion per month, helping to absorb supply. On a positive note, the Fed removed a level of uncertainty in December by announcing it would continue its current mortgage reinvestment program until the "normalization of the level of the Federal funds rate is well underway", which we believe could be at least through the latter part of 2016.

GNMAs continued to improve from their sharp selloff earlier in 2015 as prepayments (resulting from President Obama's mortgage insurance premium cut in January) fell further, which encouraged investors to add back exposure. Investor demand for GNMAs may persist in 2016, primarily from banks that are required to hold high-quality liquid assets.

At current levels, MBS spreads are now tight relative to U.S. Treasuries and relative to other high-quality fixed income sectors. In the coming quarter, MBS spreads could remain supported by the Fed's mortgage buying program but will likely be buffeted by expectations of the Fed's rate hike path. Prepayments should remain muted baring a sharp interest rate rally or resurfacing of government policy risk.

Given current valuations, we are tactically reducing MBS exposure versus U.S. Treasuries. 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 add GNMA exposure as opportunities arise.

Sources of data on this page: Mortgages, Barclays.

OUTLOOK: Underweight relative to other high-quality spread sectors.

Structured Product

Structured product spreads generally widened in Q4, though not due to fundamentals but rather market liquidity and volatility. Fundamentals are strong. The U.S. consumer spending should continue to improve as wages appear to be increasing, home values are rising, and energy prices are consumer positive. U.S. residential mortgages continue to be conservatively underwritten. Additionally, commercial real estate values are at all time highs and property cash flow is generally more than sufficient to service debt. That said, structured product leveraged business models are becoming challenged from broker/dealers, which have been required to hold more capital, to hedge funds, which will find repos more costly and less available, and for those with structurally leveraged investments (i.e., mezzanine tranches) realization of the volatility of these positions. We believe wider spreads offer a very attractive opportunity to increase allocations to senior (or near senior) tranches, and we are generally wary of mezzanine tranches due to market technicals and in some cases fundamentals. We should also note the first quarter has historically been very good for structured bonds.

CMBS—Despite recent widening in top-of-the-capital structure bonds, CMBS remains fundamentally attractive. Spreads were wider across the sector with new issue 10-year, super-senior conduit bonds roughly 15 bps wider to around Swaps+135, Agency CMBS out 15 bps to S+85a, and AAA-rated Single Asset/Single Borrower (SASB) floater spreads were slightly wider for the quarter at LIBOR +125 - 135.

Technical factors that worked against CMBS in 4Q were negative swap spreads, a decreased timeline for issuing deals due to the holidays, implementation of Regulation AB, and strong corporate issuance. That said, CMBS fundamentals remain solid. Commercial real estate values are now 17% above their 2007 peak, and both cap rates and prices appear sustainable at current levels for most asset types and geographic locations. For new issue CMBS, we have seen 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. Further, some appraisals have been frothy, but not widespread enough to cause concern at the super-senior part of the capital stack. Delinquencies in '06/'07 pre-crisis CMBS

pools remain high, but special servicers continue to work through their delinquent pipeline. Most new delinquencies are related to maturity defaults as some loans need more time to refinance. We believe losses on legacy deals will be limited to subordinate classes, such as class AJ and below.

The conduit new issue CMBS market issued $62 billion in 2015, about 15% lower than most projections early in the year. Projections for 2016 call for similar supply from conduit deals as CMBS continues to lose market share to alternatives and SASB issuance increases. SASB issuance is rising as that market provides better economic treatment for larger loans and there is no appetite from investors for larger conduit deal sizes. Fannie Mae and Freddie Mac originated $62 billion backed by multi-family properties in 2015 and issuance should be in the $70-75 billion range for 2016. The market continues to absorb new issue supply, which was about $14 billion in Q4, and new issue concessions remain 3-5 bps. While net issuance in the CMBS sector is still negative with maturities of legacy bonds outpacing new issuance, the net duration add of new issue represents a formidable technical headwind that the market will have to contend with as it refinances the wall of maturities in 2016 and 2017.

ABS—ABS spreads were again wider in Q4, similar to other front-end spread product. Spread tiering by sector and issuer also increased and broker/dealer liquidity declined due to TRACE and dealer balance allocation to commodity spread product. Higher spreads crimped new issue supply (November and December saw only $10 billion versus $20 billion in October) as some issuers chose to delay planned Q4 new issuance until 2016 in hopes of a tighter market. As a result, ABS supply for 2015 was $177 billion, trailing 2014's issuance by 7%. Spreads on benchmark credit card and auto ABS were 5-10 bps wider (e.g., 3 year AAA cards are LIBOR(L)+50 and 1 year AAA top-tier prime autos are L+45). Non-benchmark sector spreads were wider by 20-30 bps on average (e.g. 5 year senior rental car ABS to L+120 and senior 3 year sub-prime consumer loan ABS to L+215). We remain cautious on U.S. Government guaranteed Federal Family Education Loan Program Student Loans, which trade at L+125-160 bps for 3-5 year bonds, as Moody's and Fitch are still developing revised credit criteria due to slow collateral prepay performance and potential breaches of legal maturity (though we think these bonds will be repaid in full). It is likely that a large number of these bonds will be downgraded, and spreads could widen further in response to forced selling. We are neutral on benchmark sectors such as credit cards and autos with relatively low carry and limited long-term upside and look 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 remain attractive and provide exposure to conservative post-credit crisis mortgage credit underwriting. Spreads on these bonds were largely unchanged despite some volatility and now range from LIBOR+125 to 500 bps (depending upon positioning in the mezzanine stack). Senior pre-crisis legacy bond prices softened by 1 to 1½ bps in Q4 and liquidity declined despite positive technicals—annual pay-downs are approximately 15% of outstanding issues and new supply is minimal. Fundamentals continue to improve—the percent of loans making payments has been steadily increasing for over four years, home price appreciation continues to increase (we expect 5% in 2015 and 3-5% in 2016; however, higher mortgage rates present a threat), and job growth remains solid. Moreover, final approval was reached in the BofA/Countrywide settlement; $8.5 billion is expected to be paid to bondholders between February and April 2016.

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 attractively in the L + 250-315 bps range. We also find value in the senior tranche of non-performing loan securitizations, which trade at about
4.25% - 4.5% yield for front-end cash flows 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+200-250 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. The announced divestiture of £13 billion non-conforming mortgage Granite trusts by the UK government was a watershed event. In its wake, these spreads crested, and spreads on 5-year AAA bonds tightened about 15-25 bps to L+140-160 bps.

CLOs—AAA-rated U.S. collateralized loan obligation (CLO) primary market spreads widened by 2 bps to 3mL+152 bps. This brings year to date spreads close to unchanged. Spreads widened due to market volatility and ongoing 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 market AAA-rated bonds remained relatively cheap to primary issues as spreads widened due to some asset managers, who were managing fund flows, rotated out of CLOs. Lower mezzanine and equity tranches continue to be under duress and exhibit poor liquidity as senior secured loan prices continued to fall and idiosyncratic bank loan credit events. In Europe, spreads on AAA-rated CLO primary deals were 20 bps

wider at 3L+155 bps. Unlike the U.S., European demand for CLOs has not kept up with supply, and spreads have begun to converge to U.S. spreads despite better credit fundamentals and ongoing QE.

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 secondary market, we continue to see a modest premium for liquidity and believe long-term investors will benefit from current dislocation. In the long run, we strongly believe CLO spreads will compress; in the short and medium term, spreads will remain a function of supply, regulation and cross product relative value, 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 positive on GSE credit risk mezzanine cashflows. And, we are negative on CMBS and CLO mezzanine tranches.

Sources of data on this page: Structured product, Barclays; CLOs, PGIM Fixed Income.

Notice

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of January 2016.

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Performance for each sector is based upon the following indices:

- U.S. Investment Grade Corporate Bonds: Barclays U.S. Corporate Bond Index
- European Investment Grade Corporate Bonds: Barclays European Corporate Bond Index (unhedged)
- U.S. High Yield Bonds: BofA Merrill Lynch U.S. High Yield Index
- European High Yield Bonds: Merrill Lynch European Currency High Yield Index
- U.S. Senior Secured Loans: Credit Suisse Leveraged Loan Index
- European Senior Secured Loans: Credit Suisse Western European Leveraged Loan Index: All Denominations Unhedged
- Emerging Markets USD Sovereign Debt: JP Morgan Emerging Markets Bond Index Global Diversified
- Emerging Markets Local Debt (unhedged): JPMorgan Government Bond Index-Emerging Markets Global Diversified Index
- Emerging Markets Corporate Bonds: JP Morgan Corporate Emerging Markets Bond Index Broad Diversified
- Emerging Markets Currencies: JP Morgan Emerging Local Markets Index Plus
- Municipal Bonds: Barclays Municipal Bond Indices
- U.S. Treasury Bonds: Barclays 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

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