

## Curb Your Bond Enthusiasm? Not So Fast...

The first quarter of 2012 was largely a one way street, steadily reversing the damage done in 2011. Risk aversion abated, U.S. Treasury yields rose modestly, and spreads across the credit spectrum, including many European sovereigns, tightened substantially driving strong relative performance for spread product virtually across the board.

Coming in to the new year, the risk of a European meltdown loomed large, with the potential for contagion to the U.S. and global financial markets. Across virtually all fixed income spread sectors—including corporate, emerging markets, and structured product—concerns about the European sovereign crisis drove spreads to what arguably represented recessionary levels. As it turned out, the European Central Bank's ("ECB") liquidity operations calmed the European sovereign bond markets, buying precious time for European officials to kick start their fiscal and structural policy reform agendas. On the US economic front, the recovery continued, perhaps most evident in solid corporate profits and ongoing growth in private sector employment.

As we enter Q2, the key theme in the market continues to be 'worry'—with investors still gnashing their teeth over the same issues: Is China on the brink of a hard landing? Will there be a geopolitical event-driven oil price spike that kills the recovery? Will European tensions re-emerge? Will the Fed back off of its stimulus efforts, causing a surge in risk aversion and a drop off in economic activity?

While we do not dismiss these scenarios, our base case continues to be one of 'more of the same,' which is to say episodically volatile, but generally improving, conditions in the credit markets. With the economic backdrop continuing to be one of fairly moderate growth, but with both downside risks as well as elevated unemployment, the Fed is likely to continue its highly stimulative policy.

Despite the recent spike higher, we would expect 10-year U.S. Treasury yields to remain generally low and range-bound—maybe gravitating towards 2.5% in the Q2, as compared to 2% in Q1—but unlikely to move much higher given the balance of economic risks. In spread sectors, potential for volatility notwithstanding, the outlook remains positive. Slowly improving fundamentals, favorable valuations, and ongoing investor demand should prove supportive. Despite the potential for flare ups in Europe, we nonetheless expect the spread sectors—especially the higher yielding ones—to continue to generate positive excess returns over the intermediate to long term. And last but not least, with the Fed still at the head of the global central bank's 'liquidity train,' the path of least resistance over the long term for the dollar continues to be lower.

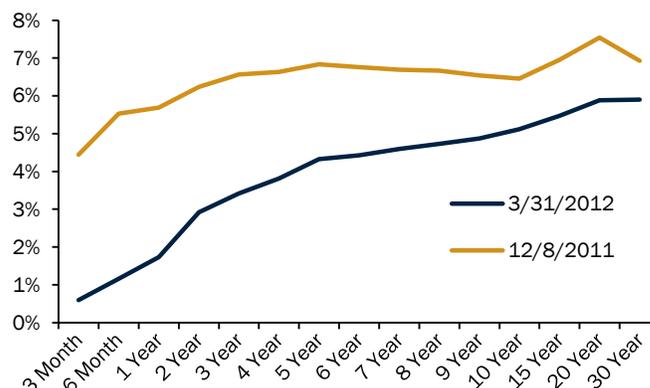
## Money Can Buy Time But Not Confidence

During the first quarter, ECB liquidity pulled the Euro Area (EA) from the brink and lifted all boats. The "all-you-can-eat LTROs" rapidly increased ECB lending to an all time high of €1.2 trillion. With 523 and 800 banks participating in the first and second LTRO, respectively, liquidity, for now, is widespread. By the end of March,

EA banks warehoused, in a "class cage" for everyone to see, €779 billion at the ECB.

These large cash balances perform two important functions. First and foremost, they insure EA banks against precarious refinancing risks. Moreover, at an interest rate of 1%, these funds invite carry trades, boost earnings and help banks rebuild capital. As a result, primary markets are beginning to thaw and select banks have begun to raise refinancing. More importantly, the liquidity has also fueled a sovereign bond rally, especially in Italy.

### Italian Government Bond Yields



Source: Bloomberg

However, the current calm could prove deceptive. EA banks need to rollover about €1.3 trillion in funding by end-2013 and nearly €2 trillion by end-2014. Depending on the market's willingness to refinance EA banks and the speed of deleveraging, these large funding requirements could eventually deplete banks' seemingly ample liquidity cushion. Undoubtedly, such an outcome would raise the specter of a renewed sovereign liquidity crisis, especially given high funding requirements in Italy and Spain.

The risk of a renewed liquidity crisis in the periphery seems only partially mitigated by the recent agreement to raise the combined funding of EA bailout funds to €700 billion. Although positive, the enhanced envelope still falls short of what may be needed. As a result, it remains doubtful whether the G20 will boost IMF resources to a significant extent. Moreover, growth prospects are weak and uneven across the EA and continued fiscal slippages raise sustainability concerns, including in Portugal and Spain. Against this background, another LTRO seems the obvious answer. However, it would be unlikely to arrive without a bruising political fight between the periphery and Europe's north, notably Germany. We therefore conclude that money can buy time but only comprehensive reform can rebuild badly shaken confidence.

**Our central themes remain broadly unchanged. We expect 10-year Treasury yields to remain low and range bound. Spread sectors, such as corporate and high yield bonds, structured product, and emerging markets debt, are likely to continue to outperform. With regard to currencies, we believe the path of least resistance for the dollar continues to be lower.**

## U.S. and European Corporate Bonds

The corporate bond market rallied in Q1 in response to the market's improved tone. U.S. investment grade corporate bonds posted a +2.08% return with spreads over similar-maturity U.S. Treasuries declining 58 bps, from 234 bps to 176 bps. European corporate bonds also performed well. Spreads on the iBoxx Euro Corporate Index tightened nearly 100 bps in response to two rounds of liquidity injections from the ECB's LTRO program and helpful tailwinds from a pick-up in U.S. growth.

Improved sentiment in Europe directly benefited the Euro banking sector, and, in turn, reduced the fear of contagion to U.S. banks. Both sectors were top performers during the period. Even the European new issue market reopened with respectable volumes. In the U.S., new issuance picked up substantially (25% ahead of last year's pace) as companies looked to lock in historically low yields. Increased new issuance was generally met by strong investor demand, but also held back further spread compression to a degree.

Underlying credit fundamentals remain exceptionally strong for most U.S. issuers, although some may be nearing a peak for this credit cycle. This year, earnings growth in the industrial and utility sectors will likely begin leveling off after years of double digit gains. Conversely, banking and finance issuers should continue to see their credit metrics steadily improve.

In Q2, we look for corporate bonds spreads to continue tightening in response to a drop in new issuance and positive U.S. growth. We favor financials over industrials given their wider spread levels, particularly U.S. money center banks that have been increasing capital, upgrading the quality of their assets, and reducing debt and leverage. Life insurance companies may also benefit from improved equity prices and the modest rise in interest rates in Q1. We see modestly attractive value in many industrial issuers, given reduced domestic recessionary concerns.

We favor U.S. corporate bonds over European bonds in global corporate portfolios due to weaker growth in the Euro zone, but are finding value in certain USD-denominated European issues. We also favor Build America Bonds, particularly index-eligible issues that are benefiting from strong demand and lack of issuance.

Despite our positive outlook for the U.S., we remain wary of weaker global economic growth and

companies dependent on global demand. In addition, mergers and acquisitions may begin picking up in the U.S., as improved business confidence leads more companies to put some of their excess cash to work. Global macroeconomic and political concerns will also cause bouts of volatility.

**OUTLOOK: Positive given healthy fundamentals, strong demand, and attractive spreads. Still favor select U.S. money center banks.**

## Leveraged Finance

Positive momentum at year-end carried right into 2012, with U.S. high yield bonds delivering a +5.2% return in Q1, following a strong +6.2% return in Q4 2011. High yield spreads over similar-maturity U.S. Treasuries tightened 95 bps, closing the quarter at 629 bps. Senior secured loans also moved higher with U.S. loans returning +3.5% in Q1 and European loans rebounding with a +10.1% return.

All high yield industries posted positive results in Q1, led by financial issues and higher beta sectors such as gaming, technology, and homebuilding. Utilities and energy lagged, due in part to falling natural gas prices and an unseasonably warm winter, which led to lower demand. Lower quality, CCC-rated issues outperformed higher quality issues.

Against a backdrop of solid fundamentals, encouraging U.S. economic data, and improving European sovereign markets, investor confidence grew steadily for higher risk products, resulting in record inflows. Fueled by stronger demand, activity in the primary market rose sharply and is now on course to outpace 2010's record year. Net supply, however, has been much lower than demand as nearly 60% of new issues were used to refinance existing debt at lower interest rates.

Despite recent strong performance, we believe the high yield bond market remains supportive. High yield spreads over U.S. Treasuries are nearing their historical averages, but still have some room to tighten. Corporate balance sheets are in good shape with most high yield companies reporting modest earnings growth, lower leverage, and elevated cash balances, which should lead to below-average defaults for the next couple of years. However, as most companies have already taken aggressive steps to shore up their finances and improve productivity, additional balance sheet and margin improvements are limited. We look for market technicals to remain supportive, but with

supply/demand more balanced than earlier this year.

In this environment, we continue to focus on bottom-up, individual security selection. We still favor issues in defensive sectors with strong secular, not cyclical, growth prospects. We find long-term value in higher quality high yield issues, but are also investing in select single B and CCC rated bonds that may benefit as the U.S. economy gains momentum. We continue to find value in short-maturity high yield bonds, and prefer U.S. over European issuers. We remain wary of issuers with significant exposure to Europe and those that were benefiting from global demand, which is likely to soften. We could also see increased volatility in light of ongoing geopolitical risks.

**OUTLOOK: Positive given still attractive spread levels and relatively low default risk, with potentially higher volatility than in Q1.**

## Emerging Markets Debt

Emerging markets (EM) fixed income performed well in Q1. Hard currency sovereign bonds posted a return of +4.25%, with lower rated countries such as Venezuela and Ivory Coast, and Eastern European countries such as Lithuania, Croatia, and Serbia, among the top performers. Investment grade Latin American and Asian sovereign debt generally lagged the major indices. EM corporate bonds outperformed sovereigns, up +4.99%, led by the metals and mining, oil and gas, and industrial sectors.

EM currencies returned +5.81% versus the dollar, with the Hungarian forint, Polish zloty, Mexican peso, and Russian ruble among the top performers. Local currency bonds (hedged to USD) lagged the recent risk rally, returning +1.76%, with the Philippines, Hungary, Russia, and Peru outperforming.

Generally strong fundamentals, improving global risk sentiment, and stable commodity prices remain the key drivers of EM performance. Economic growth and sovereign balance sheets remain solid in Asia and Latin America. Fundamentals are more idiosyncratic in EMEA countries such as Hungary and Ukraine where policy risk is an issue, although we believe that spreads adequately compensate for the near-term volatility. Policy risk is also present in China—due to a regime change—as well as Brazil, Argentina, and Turkey. In the short term, EM FX will be volatile due to the relative strength of the dollar and associated currency wars. However, over the

medium term, growth, rate differentials, and flows are still positive for EM FX.

EM debt may also be affected by local election cycles; over the past few years, elections have ultimately proven to be market neutral or positive. With the Russian election now out of the way, important elections in Mexico and Venezuela are looming. In Mexico, we expect the PRI candidate to emerge victorious in the July presidential election, which should be perceived as a market positive. In Venezuela, a regime change could produce tremendous upside. Elsewhere, the IMF program for the Ukraine is being postponed in the current pre-electoral period due to the unwillingness of policy makers to commit to unpopular reforms—we expect these issues to be resolved soon after the fall elections.

Inflows into EM remain strong and are likely to continue at a brisk pace. This should keep higher-rated issuers well bid due to supply-demand imbalances. Quasi-sovereigns continue to offer good value given their generous spreads over sovereign debt, yet comparable credit quality. Corporates, especially higher yielding corporates, are still our preferred choice when we feel comfortable with a company's fundamentals. We see local rates continuing to underperform the EM sovereign and corporate sectors and EM FX markets unless there is a big market selloff. Finally, we still find value in steep local yield curves such as Mexico, Peru, and Brazil.

**OUTLOOK: Positive. Fundamentals and technicals remain supportive. Emphasizing EM sovereign and corporate spread sectors, with secondary allocations to EM FX and local rates.**

## Municipal Bonds

Tax-exempt municipal bonds outperformed U.S. Treasuries in Q1 with the 30-year Municipal/Treasury ratio declining to 101% from 123%. Returns for intermediate maturities were more muted as supply was concentrated in that part of the yield curve. Demand remained strong with 17 weeks in a row of positive flows into municipal funds. The search for yield drove credit spreads tighter, leading lower quality credits to outperform higher quality issues. High yield municipal bonds outperformed investment grade issues by a significant margin, returning +5.4% versus +1.75%, respectively. The scarcity of taxable municipal bonds, including Build America Bonds (BABs), contributed to their strong performance in Q1 with

spreads over U.S. Treasuries tightening 62 basis points.

We expect any near-term pressure on tax-exempts due to increased supply to create a buying opportunity, as the technical picture remains positive for 2012 and should be a performance driver by end of Q2. Mutual fund flows may turn negative as the quarter begins, but should rebound as the quarter progresses. We expect the Municipal/Treasury ratios to be range-bound, with municipals outperforming U.S. Treasuries if interest rates rise, and underperforming during a rally. The continued search for yield should lead to additional spread tightening and outperformance of lower quality credits.

Preliminary state revenue growth of 2.7% in 4Q11—versus 4Q10—marks the eighth consecutive quarter of positive growth, but it also marks the smallest quarterly increase for state tax collections since 2Q10. Areas of concern include long-term unfunded pension obligations, and pressure on municipalities to balance their budgets as revenues decline and expenditures—driven by labor-related costs—rise. Additionally, potential tax reform discussions could focus on the tax advantage of municipals, creating headline risk.

Despite potential near-term supply/demand pressures, our outlook for tax-exempts remains positive as the technical picture should improve by quarter end. We expect BABs to continue to perform well based on a lack of product and demand for long duration, high-quality bonds.

**OUTLOOK: Positive based on supportive technical environment.**

## U.S. Governments

After declining steadily in early Q1, U.S. Treasury yields rose sharply in March as the improving economic outlook pushed investors out on the risk spectrum in search of more attractive opportunities. The 10-year note had its longest losing streak since 2006, but finished Q1 just 33 bps higher at 2.21%. Two-year and five-year U.S. Treasury yields rose to 0.33% and 1.04%, respectively. We expect interest rates to remain low in the coming quarter. Although much of the volatility associated with the European debt crisis has abated—along with the bid for U.S. Treasuries—the potential for another round of quantitative easing (QE3) remains on the table and should keep U.S. Treasury yields relatively range-bound through Q2.

The boost in central bank liquidity helped improve LIBOR funding during the period, which caused front-end interest rate swap spreads to tighten by 15 bps and 10-year spreads to tighten by 10 bps. In Q2, we look for front-end spreads to be stable-to-wider, and 10-year spreads to widen, as most of this liquidity effect has been priced in.

We currently hold a neutral outlook for the government agency sector versus U.S. Treasuries, but see agencies outperforming LIBOR. Continued low net supply and the final \$90 billion TLGP (Temporary Liquidity Guarantee Program) runoff and reinvestment should keep agency spreads bound to current levels.

**OUTLOOK: Underweight U.S. Governments in favor of more attractive spread sectors.**

## Mortgages

Agency mortgage-backed securities outperformed U.S. Treasuries in Q1 with a total return of +0.56% and +102 bps in excess return. Support for mortgages was steady from a variety of investors who added exposure on the belief that the Federal Reserve could announce another round of mortgage purchases (via QE3) later this year. The U.S. Treasury completed the sale of mortgages from its portfolio, which it had created during the financial crisis in an effort to stabilize the mortgage market.

Even with homeowner mortgage rates below 4%, new origination is still constrained due to tight lending standards, which has been a positive for the sector. In addition, the Federal Reserve has been absorbing supply by reinvesting paydowns from its holdings of mortgages and agency debentures back into agency mortgages in an effort to keep mortgage rates low. Demand from banks and real estate investment trusts (REITs) has also been robust.

On a more cautious note, mortgage prepayment speeds have increased relative to last year's low, sleepy levels. Some better credit borrowers have been able to take advantage of lower mortgage rates, and the impact from the latest version of the Home Affordable Refinance Program (HARP 2.0) is beginning to filter through. We expect prepayments to rise further in the coming months as HARP 2.0 fully comes online. In addition, the current low level of mortgage rates and government programs to assist homeowners have caused mortgage durations to shorten considerably. We believe mortgages may be vulnerable to duration extension risk and

convexity-related selling if U.S. Treasury yields increase and mortgage rates rise.

Currently, we favor lower coupon, 30-year mortgages and remain underweight more prepayment sensitive issues in the middle of the coupon stack. We continue to favor specified mortgage pools with call protection. Headline risk will remain high as the housing recovery remains weak and the government may seek to further enhance programs to assist homeowners.

**OUTLOOK: Neutral versus U.S. Treasuries but underweight relative to other spread sectors.**

## Structured Product

Spreads in all sectors of the structured product market tightened in Q1 in response to investors' increased risk appetite and stabilizing collateral performance. In the coming quarter, we believe more defensive, high quality securities have modest spread tightening potential, while select, slightly riskier CMBS and RMBS securities may be poised to outperform due to improving collateral performance, structural deleveraging, or the market's risk-taking appetite.

**CMBS:** High-quality CMBS spreads rallied by 40 bps to 100 bps in Q1 and continue to offer good value, although spread tightening will likely be modest for the rest of 2012. We expect investor demand to remain strong for new issues given their preference for new collateral and perceived improvements in loan underwriting. Commercial real estate values have been stabilizing, supported by increasing transaction volume over the past few quarters. The availability of credit has broadened from top-tier, "trophy" properties from institutional lenders to other well-performing properties with loan participation from banks and the CMBS market. This increasing support is likely to continue. This year, the private label new issue CMBS market is projected to issue about \$30 billion, while Fannie Mae and Freddie Mac are projected to originate about \$40 billion backed by multi-family properties. Delinquencies in CMBS loans issued in 2006 and 2007 are expected to remain high. Overall, we believe CMBS spreads remain attractive for well-researched, 'top of the capital structure' bonds.

**Consumer ABS:** Spreads on credit cards and auto ABS tightened by 5 to 10 bps in Q1 and are likely to be stable to modestly tighter through 2012. Collateral trends (losses and delinquencies) are stable. We expect consumer credit to modestly

improve along with economic prospects. We favor these securities as a defensive, lower spread volatility investment.

**Non-Agency Residential Mortgages:** Prices rose in Q1 as the Fed's successful sale of securities held in Maiden Lane II signaled that the appetite for riskier assets had reached the less liquid non-agency residential mortgage market. On a fundamental basis, housing values continue to soften but new delinquencies have stabilized, although at high levels. Non-agency residential mortgages trade at positive spreads even in stress scenarios. We believe 'top of the capital structure' bonds offer value for investors who can withstand price volatility for long-term results. Prices should remain volatile in Q2 with investment grade issues exhibiting more price stability.

**OUTLOOK: Positive on 'top of the capital structure' bonds. Positions in non-agency RMBS will likely require a long-term horizon.**

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**Performance for each sector is based upon the following indices:**

- US Investment Grade Corporate Bonds: Barclays Capital US Corporate Investment Grade Index
- European Investment Grade Corporate Bonds: iBoxx Euro Corporate Index 100% USD Hedged
- High Yield Bonds: Merrill Lynch US High Yield Master II Constrained Index
- US Senior Secured Loans: Credit Suisse Leveraged Loan Index
- European Senior Secured Loans: Credit Suisse Western European Leveraged Loan Index
- Emerging Markets US-Dollar Denominated Sovereign Debt: JP Morgan Emerging Markets Bond Index Global Diversified
- Emerging Markets Local Debt (Hedged to USD): JP Morgan Government Bond Index-Emerging Markets Global Diversified Composite Hedged USD
- Emerging Markets Corporate Bonds: JP Morgan Corporate Emerging Markets Bond Composite Index
- Emerging Markets Currencies: JP Morgan Emerging Local Markets Index Plus
- Municipal Bonds: Barclays Capital Municipal Bond Index
- US Treasury Bonds: Barclays Capital US Treasury Bond Index
- Mortgage Backed Securities: Barclays Capital US MBS - Agency Fixed Rate Index
- Commercial Mortgage-Backed Securities: Barclays Capital CMBS: ERISA Eligible Index
- US Aggregate Bond Index: Barclays Capital US Aggregate Bond Index