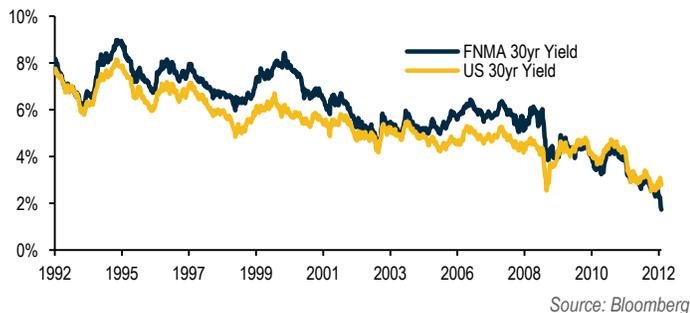


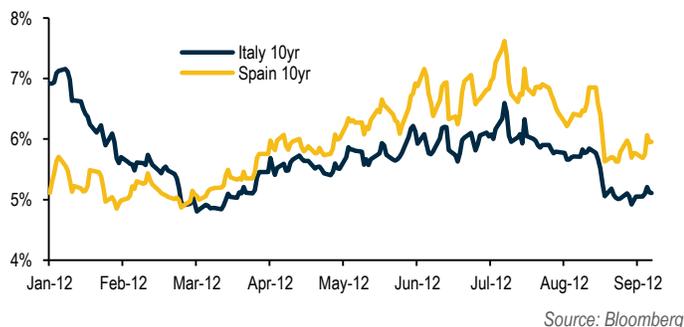
## Like A Roller Coaster—But With A Yield...

The bond market continued its roller coaster ride during the third quarter, as concerns about sluggish growth drove key central banks to further ease policy. As the European crisis threatened to spiral out of control, Mario Draghi of the ECB announced a bond purchase plan that at least temporarily reversed the tide of the crisis (see following highlighted section on The European Crisis). In the U.S., frustration with the stubbornly high rate of unemployment drove the Fed to add \$40 billion per month of net new MBS purchases to its ongoing long-dated Treasury purchases as part of Operation Twist, thus roughly doubling the amount of its long-dated securities purchases to \$85 billion. In addition, they changed their termination condition for the program to an economic state, rather than a calendar date. In other words—an ‘open ended’ commitment to buy until the economy is much better.



### “Risk On”

Although the effect of these policies on the economy remains to be seen, their impact on the markets was generally positive all around. Investor risk appetite improved, pushing stocks higher and spreads tighter over the quarter, while the impact of the Fed’s buy program further depressed Treasury yields, and drove mortgage yields to new record lows as is illustrated in the graph above. The flight-to-quality bid for the dollar subsided, allowing currencies to rally, and boosting returns on foreign bonds. Additionally—thanks to the ECBs Outright Monetary Transactions (OMT) policy announcement—even the yields on so-called European peripheral debt declined as is illustrated below.



## The European Crisis: The “Bailout Glass Cage” Needs to Be Broken

Only a commitment by ECB President Draghi “to do whatever it takes” finally halted an extensive sell-off of peripheral assets in late July. As a follow-up, the ECB introduced its framework on Outright Monetary Transactions in early September. This framework envisages secondary bond market purchases by the ECB of sovereigns supported by an EFSF/ESM program. Although its explicit purpose is to improve the transmission of monetary policy across increasingly divergent euro area (EA) economies, the OMT framework effectively establishes the ECB as a lender-of-last resort for select sovereigns.

The completion of the ratification of the European Stability Mechanism (ESM) in September added to the perception that Europe is finally serious about filling its “bailout glass cage” with liquidity. Nevertheless, both Spain and Italy remained hesitant to seek EFSF/ESM support, primarily concerned about the resulting political costs, while apparently also hoping that the mere threat of ECB interventions could keep markets “in check.”

However, renewed market concerns in late September, not only about Spain but also lingering uncertainties about a possible Greek exit, underscore that the ESM-ECB bailout framework is unlikely to gain credibility unless it is tested. Moreover, a likely bailout of the Spanish or Italian sovereign would serve to clarify whether the associated conditionality is sufficient to outweigh moral hazard concerns. Otherwise, euro area break-up expectations could flare up again, although the OMT framework has considerably reduced the possibility of a fully-fledged break-up, at least over the near to medium term.

### What’s Next?

Over the near term, market volatility could once again flare as concerns about the U.S. fiscal cliff add to the headlines coming out of Europe, and investors struggle to discern the course of economic growth. Longer term, however, we believe the impact of the Fed’s aggressive purchase program—on top of already strong global demand, from both retail and institutional investors—will exacerbate the apparent imbalance of demand over supply for fixed income. As the Fed absorbs an increasing share of the mortgage and Treasury markets, investors will be effectively forced to move into higher-yielding spread product. Additionally, we believe they will continue to migrate into foreign markets, both developed and emerging, looking for foreign currency gains and higher-yielding bond markets.

**The Bottom Line—Headline driven volatility notwithstanding, Treasury yields are likely to remain capped, while spread product remains biased to outperform. Global bond markets—both developed and emerging—will outperform as investors incrementally move abroad in search of return.**

## U.S. and European Corporate Bonds

Corporate bonds delivered strong results in Q3 primarily in response to robust investor demand, solid fundamentals in the U.S., and an easing of tensions in the European periphery. U.S. corporate bonds returned +3.83% in Q3, raising the sector's year-to-date return to +8.66%. So far this year, corporate bonds have delivered +604 bps in excess return over U.S. Treasuries, with spreads over similar-maturity U.S. Treasury bonds narrowing by 78 bps. European corporates also performed well in Q3 with spreads, as measured by the IBBox Euro Corporate Index, narrowing 59 bps to 167 bps.

Accommodative monetary policies worldwide are providing a tailwind of support to the corporate market as investors shift from low-yielding government debt into corporate bonds in search of more attractive returns. Issuers took advantage of the market's strong technical position—new issue volume rose 65% in Q3 versus the same period last year, with little or no pricing concession for U.S. issuers.

Fundamentally, we believe U.S. corporate issuers remain healthy. Despite slowing earnings, cash flow and debt coverage remain at very high levels. Going forward, we look for overall earnings to remain fairly level although some sectors, such as commodities and mining, may begin to soften in response to slower global growth. Over the past few years, most U.S. companies have strengthened their balance sheets and adopted more conservative management practices, and we believe they are well prepared to withstand the current slow growth environment.

Across sectors, we still favor financials over industrials given their wider spread levels, improving credit metrics, and more attractive return potential. U.S. money center banks, for example, were among the top performing sectors in Q3. Banks have continued to build capital, improve their business lines, and reduce debt and leverage. We see modestly attractive value across the industrial sector, although issue selection is key.

We continue to favor U.S. corporate bonds over European bonds in global corporate portfolios due to recessionary concerns in the euro-zone. However, we are finding value in certain USD-denominated European issues. We also favor short-term BBB-rated issues and Build America Bonds, particularly index-eligible issues that are benefiting from strong demand and lack of supply. We hold a cautious outlook on commodities, metals, and mining given the downturn in global growth. Although positive overall, we remain guarded over recessionary concerns in Europe and uncertainly regarding the U.S. fiscal cliff.

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

## Leveraged Finance

High yield bonds delivered a healthy +4.61% return in Q3, lifting their year-to-date return to +11.98%. The average yield on the broad high yield market rallied 78 bps, ending the period at 6.5%, an all-time low. Relative to similar-maturity U.S. Treasury yields, however, high yield bond spreads remain fairly wide on an historical basis compared to other periods with similarly low default rates. Lower-quality, CCC-rated bonds performed slightly better than the market average this period due to their higher yields. On price basis alone, returns were consistent across the quality tiers.

U.S. senior secured loans also delivered solid gains with a +3.14% quarterly return, while European loans returned +2.52%. Year-to-date, U.S. loans are up +7.80%, while European loans returned +8.23%.

Momentum in the high yield market was driven primarily by strong technicals as investors' thirst for yield outweighed signs of slowing global economic growth. Activity in the new issue market reached near record levels, but with almost 60% of issuance used to refinance existing debt, net supply was manageable. U.S. loan market technicals were also fairly strong given healthy fund inflows and a pick-up in CLO issuance versus limited new supply.

Across sectors, telecommunications, electric utilities, and financials were the best performers, all up more than 6%. Food and drug retailers was the only sector in negative territory.

Although fundamentals and earnings generally remain solid across a wide range of industries and companies, waning business confidence in the face of uncertain macro factors and the U.S. fiscal cliff should weigh on capital expenditures through year end. Further balance sheet and margin improvement via cost cutting is unlikely, as most companies have already trimmed expenses over the past few years. We look for companies with more exposure to the U.S. consumer to see flat or modestly higher profits in Q4, while those that were benefiting from global and European demand will be more challenged. We look for U.S. defaults to remain below the long-run average of 5% over the next couple of years, but for European defaults to rise in response to recessionary conditions.

In this environment, we continue to focus on issuers with positive secular growth trends that we believe are better positioned to withstand a protracted slowdown in the global economy. We prefer issuers in defensive sectors, such as gaming, cable, and healthcare, but are also finding value in select cyclical credits whose yield levels are commensurate with underlying risks. Individual issue selection is key, especially in the primary market where underwriting standards have begun to weaken. We continue to find value in shorter-maturity issues, especially those that may benefit

from an early tender call. We remain wary of issuers subject to shareholder-friendly leveraging transactions, both in the primary and secondary markets.

Overall, we believe valuations and supply/demand technicals remain supportive in the high yield market, especially for higher-quality U.S. issuers that are not as vulnerable to macroeconomic issues.

**OUTLOOK: Positive longer term. Fundamentals, valuations, and technicals are supportive but we expect short-term volatility to remain high due to earnings uncertainty and macroeconomic concerns.**

## Emerging Markets Debt

Emerging markets debt delivered strong results in Q3 with positive returns across all sectors. Hard currency bonds lead the quarter and year-to-date periods with returns of +6.64% and +14.24%, respectively. Emerging markets corporate bonds followed with returns of +4.76% in Q3 and +11.83% so far this year. Emerging markets FX and local currency bonds (hedged) returned +3.14% and +1.87%, respectively, for Q3, and +6.26% and +6.03% year-to-date. The returns of emerging markets FX have been more volatile, reflecting broader global concerns, while the modest returns of local rates reflect market expectations for fewer interest rate cuts going forward.

In this post-QE3 environment, we believe emerging markets debt continues to offer relatively attractive spreads and valuations, with specific country, sector, and issuer selection playing an increasingly important role. Investors' risk appetite remained strong in Q3 with positive inflows into the sector, especially for emerging markets hard currency bonds. As in prior quarters, higher-yielding, lower-rated countries continued to outpace lower beta issues.

From a growth perspective, emerging markets have exhibited significant resiliency in the face of considerable global volatility over the past four years. Although economic growth for the sector as a whole is still stronger than in developed countries, several key emerging economies, including Brazil and China, slowed in the first half of 2012, primarily due to weaker global trade. Even so, relatively healthy fundamentals otherwise—more robust domestic demand, solid public sector debt dynamics and fiscal balances—helped limit the downside. Going forward, we look for Brazil and to a lesser extent China to post modest recoveries as they benefit from recent stimulus measures, helping overall emerging markets growth move back towards 5% by 2013. The Central and Eastern European regions should continue to display weaker dynamics given their trade-links and closer ties to the euro-zone.

Currently, we favor a barbell investment approach: shorter-duration, higher-yielding issuers, such as Venezuela, where credit concerns are compensated with very high yields, offset with longer-term securities from investment-grade countries with steep yield curves, such as Mexico, Russia, and South Africa. We also like the high nominal yield of local Brazilian bonds where we believe excessive rate hikes are priced in, and inflation-linked bonds in both Brazil and Turkey. We continue to find value in attractively-priced quasi-sovereign bonds and in high-quality emerging markets corporate bonds.

We look for emerging markets FX to offer attractive returns over the medium term given the prospect for strong growth, better flows, and higher yields. Near term, FX could exhibit excess volatility in response to deliberate interventions to stem currency appreciation to restore competitiveness. In some countries, FX may be volatile due to the prospect of central bank rate cuts to counteract slowing growth. The key to profiting from FX and local rates is identifying fundamental value weighed against policy risk and risk sentiment.

**OUTLOOK: Positive given strong demand and attractive valuations.**

## Municipal Bonds

Tax-exempt municipal bonds outperformed U.S. Treasuries in Q3 with the 30-year Municipal/Treasury ratio declining to 101% from 114%. During Q3, high yield municipal bonds returned +3.87%, handily outperforming investment grade issues, at +2.32%. Year-to-date, high yield municipal bonds outperformed investment grade issues by a significant margin, +13.89% versus +6.06%.

A solid technical backdrop continued to help drive performance in Q3, as it has all year. Positive flows into tax-exempt municipal funds, in excess of \$39 billion this year, combined with strong reinvestment proceeds, enabled the market to easily absorb new issue supply. Credit spreads remained attractive given the low interest rate environment and investor demand for incremental yield. Demand for index eligible taxable municipals, including Build America Bonds (BABs), remained robust, contributing to tighter spreads and strong excess returns.

On the budget front, preliminary state tax revenues for Q2 were higher by 3%, marking the 10<sup>th</sup> consecutive quarterly increase. Despite this improvement, many states and localities still face challenges balancing their budgets. Several municipalities filed for bankruptcy protection in 2012, but we believe these to be the exception rather than the rule given the stigma and negative repercussions associated with filing. For example, larger issuers with ongoing capital needs will not likely risk losing future market access by filing for bankruptcy. In addition, states do not have the ability to file

for bankruptcy. Longer term, unfunded pensions remain a concern, although we recognize that reforms are progressing in many states and localities.

We expect a less favorable technical environment in tax-exempt bonds through November; however, we believe the picture should change by year end as the positive effects of January 1<sup>st</sup> reinvestments support the market. Demand may also rise in response to higher investment income taxes associated with the Affordable Care Act, and potentially higher individual income tax rates if the Bush tax cuts expire. Offsetting these positives is uncertainty regarding potential tax reform in 2013 and its impact on tax exemption. While demand for taxable municipal bonds, including BABs, has been strong, potential subsidy cuts under sequestration may cause volatility going forward. We do not believe these potential cuts are a significant negative from a credit perspective for major issuers, but they may lead to headline risk and the elimination of BAB-like programs in the future.

**OUTLOOK: Neutral given policy overhang, despite other positive forces.**

## U.S. Governments

The U.S. Treasury yield curve steepened in Q3 as shorter-term yields declined 7 to 9 bps, 10-year yields held steady, and longer-term, 30-year yields rose by 6 bps to 2.82%. The yield differential between 2-year and 30-year U.S. Treasury bonds widened to 259 bps. Yields were moderately volatile during the period, first declining in July in a flight-to-quality bid, rising in August as tensions in Europe eased, and then declining again in response to weaker U.S. growth and the Fed's QE3 announcement. The Fed vowed to keep short-term rates low into 2015, and will continue its Operation Twist program (selling short-term bonds while purchasing longer-term securities) until the end of 2012.

Implied interest rate volatility was relatively unchanged, while swap spreads continued their trend tighter, particularly in the front end of the yield curve, as central bank liquidity remained abundant. In Q4, we look for interest rate swap spreads to widen marginally given uncertainty over the euro-zone crisis and U.S. fiscal cliff, and as the Fed's Operation Twist program continues to absorb a majority of 10-year U.S. Treasury supply.

U.S. government agency bonds outperformed U.S. Treasuries during the period with an excess return of +37 bps, bringing their year-to-date excess return to +86 bps. Agency bonds continued to benefit from low net supply and strong investor demand for AAA-quality bonds.

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

## Mortgages

The Federal Reserve's third round of quantitative easing, announced at the September FOMC meeting, sparked a sharp rally in agency mortgage-backed securities, with lower-coupon issues significantly outperforming higher-coupon bonds. Agency mortgage-backed securities outperformed U.S. Treasuries in Q3 with a total return of +1.13% and +71 bps in excess return. Year-to-date, mortgages have delivered +115 bps in excess return relative to U.S. Treasuries.

Troubled by the high level of unemployment, the Fed tied this round of easing to an improvement in labor conditions. The Fed plans to buy \$40 billion in agency mortgage securities per month, in addition to reinvesting its portfolio paydowns of mortgage and agency debt. It's estimated that the Fed's total gross purchases of about \$77 billion per month, at current prepayment speeds, will absorb almost two-thirds of gross issuance. The Fed's buying program is designed to inject money into the financial markets and support economic growth. Homeowner mortgage rates in turn should decline, promoting housing stability and encouraging refinance activity.

The Fed's large purchase activity has created a dramatic technical shift in the mortgage-backed securities market. The Fed is focused on buying lower-coupon bonds, spreading its purchase activity among various maturities and agencies. However, given the timing differential between origination and Fed purchases, lower-coupon bonds may experience massive price dislocations until origination fills in. The marked improvement in lower-coupon dollar roll financing levels demonstrates the supply and demand imbalances, although the Fed is now dollar rolling some coupons to help alleviate the technical supply imbalance. We ultimately expect prepayment speeds to increase in lower coupon bonds, specifically 30-year, 3.5% and 4% coupons, which are less credit impaired than higher-coupon mortgages. The ongoing Home Affordable Refinance Program (HARP 2.0) has already increased higher-coupon prepayment speeds to date, but will likely show some burnout going forward.

In this environment, we continue to favor production coupons and remain underweight more prepayment sensitive issues. We also favor specified mortgage pools with call protection, as well as GNMA and Freddie Mac securities relative to FNMA's. We expect the potential for government policy actions to decline in Q4 as lower mortgage rates take hold and the November elections take center stage.

**OUTLOOK: Neutral versus U.S. Treasuries. Mortgages have rallied sharply but ongoing Fed buying may cause them to outperform even further. Look for tactical trading opportunities around the Fed buying program. Underweight relative to other spread sectors.**

## Structured Product

Non-agency and CMBS bonds rallied strongly in Q3 while ABS spreads were modestly tighter.

*CMBS:* High-quality CMBS spreads rallied by about 50 bps in Q3, but in our opinion, continue to offer good value as high-quality, short-duration securities. Commercial real estate values continued to stabilize and the availability of credit improved, broadening from top-tier, “trophy” properties to other well-performing properties in the secondary markets. We look for investor demand to remain strong for new issues even though the credit underwriting standards for some CMBS loans has begun to relax relative to conservative post-financial crisis standards.

This year, the CMBS market is projected to issue about \$35 billion, while Fannie Mae and Freddie Mac are projected to originate about \$45 billion of loans backed by multi-family properties. Despite this increase in volume, new supply is still less than the volume of maturing CMBS bonds, adding a positive technical to the market. Delinquencies in CMBS loans issued in 2006 and 2007 remain at historically high levels, but appear to have stabilized. Overall, we believe CMBS spreads remain attractive for well-researched bonds with significant credit enhancement relative to loan loss assumptions.

*Consumer ABS:* Spreads on credit cards and auto ABS were modestly tighter in Q3 and are likely to remain stable through the balance of the year. Collateral performance (losses and delinquencies) remained stable. Overall, we expect consumer credit to move modestly with the direction of the economy. We favor credit card and auto securities as defensive, lower spread volatility investments. We also find value in fundamentally strong, off-the-run senior ABS tranches as a front-end carry investment.

*Non-Agency Residential Mortgages:* Prices rallied sharply in Q3 with select seasoned, sub-prime bonds returning close to +5%. On a fundamental basis, housing values appear to have stabilized, although there are still about 4 million delinquent mortgages nationwide, or about 8% of all mortgages. Credit availability for new non-agency loans remains restricted; about 90% of all mortgages are originated into government programs. Nonetheless, non-agency residential mortgages still trade at positive spreads even in adverse scenarios. We believe well-enhanced bonds offer value for investors who can withstand price volatility for long-term results.

In Q4, we look for low spread volatility on high-quality CMBS and ABS. Riskier securities, such as non-agency RMBS, should trade directionally with the broader fixed income spread market, but with a positive skew.

**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