

The More Things Change, The More They Remain The Same

The fourth quarter of 2011 felt like just another mini-cycle within what has become a multi-year European sovereign crisis. It came with all of the component parts we've come to expect—European sovereign debt markets under pressure as a result of fundamental concerns, official actions taken to contain and correct the situation, a brief recovery, then investors conclude the steps taken are inadequate to contain the crisis—rinse and repeat. In the case of the fourth quarter, though, there were *three* mini-cycles as a result of summits in October and December, and a smaller Franco-German summit in November.

In contrast to the doom and gloom hue cast in Europe, growth in the U.S., although modest by some measures, has at least been on an improving trajectory over the course of the year. GDP registered gains of 0.4%, 1.3%, and 1.8% in the 1st, 2nd, and 3rd quarters respectively, and is currently forecast to be around 3% in the fourth quarter.

While strong economic data pushed U.S. Treasury yields higher in October, the combination of consistent Federal Reserve buying and strong investor demand for high quality, liquid, USD-denominated assets ultimately brought Treasury yields back down towards the generational lows hit late in the third quarter. The rising tide of Treasury prices lifted all boats, allowing most fixed income sectors to post solid *absolute* returns for 2011. Investors' strong preference for liquidity and quality, however, caused the spread sectors, such as corporate and emerging market bonds, to underperform U.S. Treasuries on a *relative* basis despite, in many cases, stable-to-improving fundamental trends. Similarly, most currencies—even those with favorable fundamental backdrops—fell versus the U.S. dollar as investors looked for a safe harbor.

As we head into 2012, policy makers will continue their efforts to contain the crisis in Europe. The strong performance of the European peripheral markets in the final weeks of 2011 may fade in the first quarter of 2012, as a heavy schedule of government bond auctions has the potential to overwhelm the markets. At a minimum, the absence of a 'silver bullet' solution to the problems in Europe suggests market volatility will remain high. And, unfortunately, while the probability may be small, a Euro breakup scenario cannot be ruled out. Also, while the recent

shuttering of MF Global validated fears of the financial system's fragility, the recent passing of North Korea's Kim Jong II and activity in Iran serve to keep geopolitical risks in the forefront, as well.

Fixed Income Performance by Sector

(Sorted by 2011 Total Returns)

| | Total Return (%) | |
|----------------------------------|------------------|------|
| | 2011 | Q4 |
| Municipal Bonds | 10.70 | 2.12 |
| U.S. Treasuries | 9.81 | 0.89 |
| U.S. IG Corporate Bonds | 8.15 | 1.93 |
| U.S. Aggregate | 7.84 | 1.12 |
| Emerging Markets Sovereign Debt | 7.35 | 4.65 |
| Mortgage-Backed (Agency) | 6.32 | 0.89 |
| Commercial Mtg-Backed Securities | 6.02 | 3.11 |
| U.S. High Yield Bonds | 4.38 | 6.18 |
| U.S. Senior Secured Loans | 1.82 | 1.21 |
| European IG Corporate Bonds | 1.72 | 1.33 |

Sources: Barclays Capital except EMD (JPMorgan), HY (Merrill Lynch), and Euro Corp (iBoxx). Performance is for representative indices as of Dec. 31, 2011. See Notes for full index names. Past performance is not a guarantee or a reliable indicator of future results.

Despite the dampening effect of the European crisis, in our base case scenario, the U.S. recovery is expected to continue. While fiscal consolidation may temper growth slightly in 2012, it is not expected to start in earnest until 2013. As a result, we expect credit fundamentals to remain robust. With unemployment high and inflation low, however, the Fed is likely to continue to maintain supportive monetary policies, thus depressing U.S. Treasury yields at least through the first half, if not all, of 2012. With money market and U.S. Treasury yields low, and stock prices volatile, we expect investors to continue to search for yield in the non-Treasury fixed income sectors. Spreads remain at attractive levels and demand is strong, so we expect solid relative, if not absolute, returns in 2012. And despite the potential for near term turbulence, we expect fundamentals to reassert themselves in the long run, leading the U.S. dollar to resume its decline versus developed and developing countries with comparatively favorable growth and debt dynamics.

Despite the 2011 bull market in U.S. Treasuries, we believe there is still value to be found in fixed income. While markets may remain volatile, spread sectors, such as corporate bonds, structured product, and emerging markets, are likely to outperform in 2012.

U.S. and European Corporate Bonds

U.S. investment grade corporate bonds delivered a +1.93% return in Q4, lifting the sector's full-year return to +8.15%. Corporate spreads over U.S. Treasuries were volatile yet relatively unchanged for the quarter. For the year, spreads were nearly 80 bps higher, closing at 234 bps over U.S. Treasuries. Despite strong earnings, corporate bonds remained volatile in Q4 due to concerns over the European debt crisis, questions surrounding US bank exposure to the crisis, and the prospect of an economic contraction in Europe. A spike in new issuance and the more risk averse stance of many broker dealers also weighed on the market at times. European corporate bonds were particularly vulnerable with spreads widening 130 bps for the year.

We continue to hold a favorable outlook for U.S. corporate bonds. Credit fundamentals remain solid, supported by high cash positions, healthy balance sheets, and more conservative management. Most U.S. companies are well positioned should global growth begin to soften.

On the technical side, yields are generous relative to the ultra-low rates on government debt. In fact, the yield spreads of many issuers are now trading near recessionary levels, far higher than is typical at this stage of the credit cycle. The new issue market has been well-subscribed with strong demand from yield-oriented investors who are reluctant to invest in riskier asset classes, and from pension funds looking to better match their liabilities.

Although we hold a favorable view on corporate spreads, we are currently positioning portfolios to guard against the possibility of somewhat weaker global growth in the coming year. We favor U.S. over European issuers, and are cautious on select cyclical companies and commodity companies dependent on global growth. We continue to find value in Build America Bonds (BABs), particularly index-eligible issues that are benefiting from strong investor demand.

In addition, we remain biased toward select U.S. money center banks that we believe are well positioned to withstand the European financial crisis. Many of these larger banks have continued to improve their credit profiles by increasing capital, upgrading the quality of their assets, and reducing debt. Tighter government regulations that require additional capital buffers and more conservative balance sheets provide additional support. In contrast, we remain cautious-to-negative on the

European bank sector in general. In response to heightened volatility across the European markets, we are taking advantage of increasing price discrepancies/spread deviations of issuers with bonds denominated in both U.S. dollars and euros.

We look for market volatility to remain high until European policymakers ultimately address their financial and sovereign risk issues.

OUTLOOK: Positive given still healthy fundamentals and higher spreads. Still favorable on select U.S. money center banks.

Leveraged Finance

U.S. high yield bonds rebounded during a volatile Q4 to deliver +6.18% in return for the quarter and +4.38% for the year. High yield spreads over similar-maturity U.S. Treasuries tightened 84 bps in Q4, but were 141 bps wider for the year at 724 bps over U.S. Treasuries. U.S. senior secured loan prices also rose in Q4 to deliver a +1.82% annual return, while European senior secured loans continued to struggle, down -0.83% for the 12 months.

For the year as a whole, higher quality high yield bonds and defensive issuers outpaced lower quality, cyclical credits. BB rated issues delivered +6.12% in return, significantly higher than the -1.40% return for CCC rated issues. The top performing industries were the food and drug, cable, energy, lodging, and electric sectors. The airline industry was the worst performing sector, pressured by AMR's bankruptcy filing in November.

We believe the high yield bond market is poised to perform well going into 2012. Fundamentally, issuer credit metrics generally remain solid with most U.S. high yield companies reporting modest earnings growth in Q4, despite the recent slowdown in global growth. Most issuers are maintaining high levels of liquidity on their balance sheets, having learned their lesson from the liquidity freeze in 2008. In addition, due to historically low rates, the interest burden on U.S. high yield companies is the lowest it has ever been. In all, we expect default rates for U.S. credits to rise marginally in 2012 but remain well below the historical average.

The market's technical position is also favorable. High yield bond spreads are fairly wide on a historical basis, the new issue market has been manageable, and investor demand for the sector should remain healthy given the extremely low rates offered by alternative fixed income investments.

The exception to our outlook: issuers with significant exposure to Europe and those that have benefited from global demand. Given the risk of recession in the eurozone, and slower global growth trends overall, a number of these issuers may come under pressure in the coming year.

In this type of environment, fundamental analysis and due diligence are extremely important. Currently, we prefer defensive sectors and issuers with a strong secular backdrop, but will invest selectively in more cyclical issues that we believe are oversold but still have solid fundamentals. We are also finding value in short-maturity, higher quality high yield bonds and prefer U.S. over European issuers.

OUTLOOK: Positive given generous spread levels and relatively low default risk. However, lingering concerns over the European financial crisis may keep volatility high and temper significant spread compression.

Emerging Markets Debt

Emerging markets (EM) sovereign USD-denominated bonds produced solid returns of +4.65 % in Q4 and +7.35% year-to-date. EM local bonds (hedged to USD) advanced +1.07% and +4.49% in Q4 and full-year 2011, respectively. For the year, the spreads of sovereign USD-denominated debt widened by 130 bps, to 404 bps over U.S. Treasuries. EM corporate bond spreads also widened with the sector delivering just +2.32% in return for the year. EM currencies lagged with returns of -1.0% in Q4 and -5.19% in 2011.

In 2012, we look for economic growth in emerging countries to continue to outpace the developed world. Growth in China and India will likely slow, but only to about 8.0% and 7.3% respectively. These figures assume that China effectively manages its real estate bubble while engineering a soft landing, and India overcomes its significant inflation problem and recent exchange rate volatility. Latin American and Asian economies should also slow but still produce positive growth, while remaining sensitive to EU/U.S. economic slowdowns and shocks. Conversely, Central and Eastern European countries may be impaired more severely by their linkages to Western Europe. Overall, emerging economies should continue to benefit from better sovereign creditworthiness, generally better demographics (except in China and Eastern Europe), higher productivity growth, and investment flows.

Across all emerging market sectors, we are currently emphasizing strategies that require lower turnover and should perform well through attractive carry. In the hard currency markets, we continue to advocate a barbell strategy that overweights riskier countries and corporate bonds with maturities of five years and under combined with 30-year securities of higher-rated countries, to add duration and take advantage of relatively steep yield curves. We favor the shorter maturity bonds of Argentina, Venezuela, and Ukraine, and the longer maturity bonds of Mexico, Brazil, and South Africa. We are also finding value in many quasi-sovereigns, such as Pemex, Mexico's state-owned oil company, and KazMunaiGaz, Kazakhstan's national oil and gas company, which trade at significant spreads over sovereign bonds yet have very similar credit risk.

In the local markets, a softer economic outlook has predisposed many countries to reduce interest rates or defer rate hikes. In some countries, such as Hungary, volatile currency and interest rate movements might preclude easing as a policy option. Currently, we are overweight three-to eight-year maturities in Mexico, South Africa, and Peru where the local yield curves are steep and it appears the markets are overestimating a future rise in interest rates. We also hold long-term overweights in countries with positive real yields and favorable secular trends, such as Brazil.

We remain biased toward EM currencies versus developed market currencies over the long term. Although EM currencies are highly correlated to risk aversion stemming from Europe and other developed markets, they are attractively priced and offer tactical opportunities. We favor Latin American and Asian currencies with higher yields and strong balance of payments, such as the Mexican peso, Malaysian ringgit, and Brazilian real.

OUTLOOK: Positive. Fundamentals and technicals remain supportive. Tactically cautious and emphasizing strategies that require lower turnover.

Municipal Bonds

Intermediate tax-exempt municipal bonds outperformed US Treasuries in Q4 with the 10-year Municipal/Treasury yield ratio declining to 98% from 115%. Longer municipals performed in line with Treasuries with the 30-year Municipal/Treasury yield ratio only slightly higher at 123%. Returns were driven by strong investor demand combined with manageable supply. Improving state revenue receipts also contributed to the market's positive

tone. Tax-exempt municipal bonds rebounded from early year underperformance to become one of the best performing fixed income sectors in 2011. Investment grade and high yield municipal bonds produced returns of +2.12% and +0.79%, respectively, in Q4 and +10.70% and +9.25% in 2011. The scarcity of taxable municipal bonds, including Build America Bonds (BABs), contributed to their strong performance in 2011 with a total return of +23.81%.

In 2012, we look for positive technicals to support the market through at least February, given low net supply levels. We also expect Municipal/Treasury ratios to decline from current levels. Investors seeking additional yield may begin extending into longer-term securities, causing the yield curve to flatten, while credit spreads should narrow as lower quality investment grade credits attract more investors.

Although most states and localities continue to experience revenue growth, issuers may still need to cut expenses and explore alternative revenue sources to offset federal and state aid shortfalls. Unfunded pension obligations will continue to generate attention and further reforms are likely. The proposed Volcker rule and potential for tax reform discussions could result in headline risk and increased uncertainty.

Our outlook is positive overall for tax-exempts based on supportive technicals, but the potential for policy discussions may increase volatility. We expect BABs to perform in line with investment grade corporate bonds based on their relative value and strong demand.

OUTLOOK: Positive based on supportive technical environment.

U.S. Governments

U.S. Treasuries continued to benefit from their “safe haven” status in the wake of continued global financial stress and Europe’s ongoing sovereign debt crisis. The rally in U.S. Treasury yields, however, appeared to run out of steam in Q4. During the period, two-year U.S. Treasury yields were unchanged at 0.25%, 10-year yields fell 4 bps to close at 1.88%, and 30-year yields declined 2 bps to 2.90%. Despite improving economic conditions in the U.S., strong investor demand and the Federal Reserve’s purchases of longer-dated securities are helping to keep yields depressed.

We look for interest rates to remain low in the coming quarter with intermittent periods of volatility in response to the European financial crisis and the Federal Reserve’s debate whether to implement another round of quantitative easing (QE3). We currently hold a neutral outlook for the government agency sector, given that low net supply and the reinvestment of paydowns from the TLGP (Temporary Liquidity Guarantee Program) should keep spreads at current levels. In the interest rate swap market, we expect LIBOR (London Interbank Offered Rate) stress to abate with shorter maturities outperforming the 10-year sector, and the swap curve steepening relative to the U.S. Treasury yield curve.

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

Mortgages

Agency mortgage-backed securities performed relatively well in Q4 as spreads over similar-maturity U.S. Treasuries narrowed to the tighter end of their recent range. Mortgages posted a total return of +0.89% in Q4 and +6.32% in 2011, but lagged U.S. Treasuries for the year with -113 bps in excess return as the flight-to-quality rally took its toll on spread products.

During the period, the U.S. government finalized details of its latest refinancing initiative, the Home Affordable Refinance Program (HARP 2.0), and the market seems comfortable that prepayment speeds will not surge as high as initially feared. Success of this program will depend on mortgage servicer participation. In addition, new mortgage production should remain low given tight credit conditions and the weak housing market.

The Federal Reserve continues to provide support by reinvesting paydowns from its holdings of mortgages and agency debentures back into agency mortgages in an effort to keep homeowner rates low. Finally, Fed officials stated that agency mortgages may be purchased should they implement QE3.

Currently, we hold a modestly positive outlook for mortgages versus U.S. Treasuries but prefer other spread sectors due to their greater upside potential. We favor 30-year current coupon mortgages and are underweight more prepayment sensitive issues in the middle of the coupon stack. Specified mortgage pools with call protection will be important to avoid fast prepayment speeds. Headline risk will remain high as the housing recovery remains weak and the

government may seek to further enhance programs to assist homeowners.

OUTLOOK: Positive versus U.S. Governments but underweight relative to other spread sectors.

volatile in Q1 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.

Structured Product

High-quality commercial mortgage-backed securities (CMBS) rallied in Q4 but were also subject to periodic spread widening in response to adverse macroeconomic conditions. High-quality consumer asset-backed securities (ABS) and collateralized loan obligations (CLOs) were generally defensive while non-agency residential mortgage securities (RMBS) experienced slight price declines and reduced liquidity, particularly for non-investment grade issues.

CMBS: High-quality CMBS spreads rallied by 50 to 90 bps in Q4 and we believe still offer good value with room for further spread tightening in 2012. Commercial real estate values have been stable, although transaction volume is limited. Top-tier, "trophy" properties have ample credit available from institutional lenders while credit for other well-performing properties has been mixed due to fits-and-starts in the CMBS loan market. The new issue CMBS market re-opened in 2011 but net volume was at the low end of projections at about \$30 billion. Similar volume is expected in 2012. Delinquencies in CMBS loans issued in 2007 and earlier have stabilized, but remain high, particularly for 2006 and 2007 collateral (over 10%). Overall, we believe CMBS spreads remain attractive for well-researched, 'top of the capital structure' bonds.

Consumer ABS: Spreads on AAA-rated credit cards and auto ABS were generally range bound in Q4 and are likely to remain so going into 2012. Collateral trends (losses and delinquencies) are exhibiting stability. We expect these high quality bonds to remain well bid and generally defensive.

Non-Agency Mortgages: Prices declined slightly in Q4. More importantly, trading liquidity began to deteriorate during the quarter due to tighter regulatory capital requirements for broker dealers and continued investor risk aversion for below-investment grade bonds. On a fundamental basis, housing values continue to soften but the incidence of new delinquencies has stabilized, although at high levels. That said, most non-agency 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. Trading levels should remain

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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