PGIM FIXED INCOME

TIME TO RE-LOAD?

Current High Yield Bond Prices Present Long-Term Value

- **Risk aversion and energy woes have weighed down the high yield bond sector as a whole**
- **In many cases, prices trade below fundamental valuations**
- **Individual issue selection is of key importance**

Global risk markets have been under pressure lately due to a confluence of factors—weakness in China and other global economies, plunging oil and commodity prices, and the onset of the removal of monetary accommodation by the U.S. Federal Reserve. Against this backdrop, we believe the broad selloff in the credit markets has been excessive relative to underlying fundamentals, resulting in attractive valuations across the European and U.S. high yield markets. Below, we outline several themes that we believe can offer particular value today.

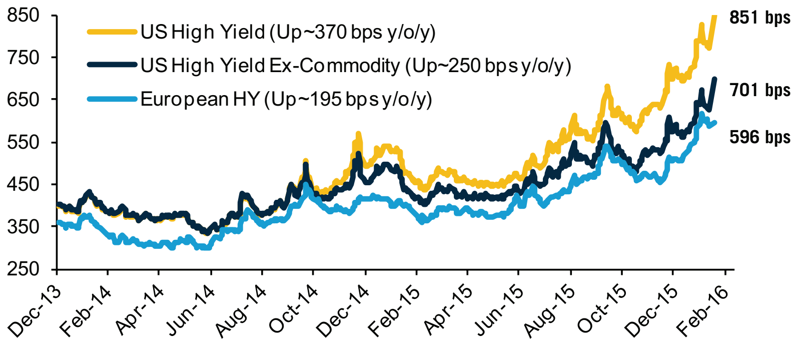
U.S. *Excluding* Energy and Other Commodity Sectors[1]

Outside of the troubled energy and commodity sectors, U.S. high yield spreads were roughly +700 bps in early February, their highest level since 2011. Across many of these sectors, spreads have been pushed higher by indiscriminate selling as risk-aversion has taken hold, not, as many may think, by a sharp downturn in fundamentals or poor U.S. growth prospects. In fact, the current spread level of the ex-energy and commodity sectors implies an average annual default rate topping 6.0%, more than twice the level likely to occur. We believe the actual default rate for the less cyclical parts of the U.S. market should average in the low single digits, leaving numerous 'diamonds in the rough' for discriminating investors who can withstand volatility. Conversely, defaults in the energy and other commodity sectors in 2016 may come in higher than the 18-20% rate implied by current prices.

Europe Across All Industries[1]

The European high yield bond market, which has little exposure to the energy and metals/mining sectors, is of higher quality than its U.S. counterpart (about 70% BB-rated bonds in Europe), and could benefit from stable-to-improving growth, a weaker euro, and quantitative easing. High yield spreads stood at +596 bps in early February, up about 195 bps in the past year. Here, too, we expect the default rate to be much lower than the rate implied by current market prices (1-2% expected vs. 5% priced-in). Additionally, while the headline yield in the European high yield market is much lower than the U.S.—5.9% vs. 9.8%, respectively —we believe, on a risk-adjusted basis (removing the risk-free rate and relative to quality weightings), the spreads are very comparable. As such, we hold a constructive view of the European high yield market with individual issue selection of key importance.

High Yield Bond Spreads Are Meaningfully Higher Than Last Year[1] (bps)



Default Rate Expectations (%)	2015	2016 (f)	Avg. Annual Default Rate Priced into Market
European HY	0.1	1.0	4.75 – 5.25
US HY Ex-Commodity	1.5	2.3	6 – 7
US HY Commodity	8.4	12.1	18 – 20

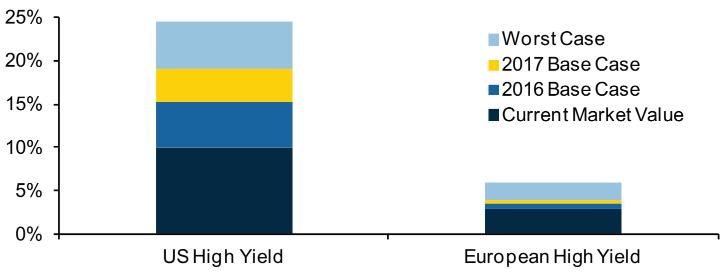
1. Sources for above charts and data: PGIM Fixed Income and Bank of America Merrill Lynch as of February 8, 2016. Represents spread and yield data for the Bank of America Merrill Lynch US High Yield Index and European Currency High Yield Index. Bank of America Merrill Lynch 2015 and 2016 default rates are based on issuer count as of December 31, 2015. PGIM Fixed Income default rates priced into the market are based on spreads as of February 8, 2016.

Fallen Angels New to the High Yield Bond Universe

During the next several years, we expect an influx of downgraded energy and commodity-related 'fallen angels' to enter the high yield bond universe. Depending on whether oil prices trade at levels near $30/bbl, or drift higher into the $40-50/bbl range (our base case), the high yield energy sector could grow to comprise 15-25% of the U.S. market over the next two years. In Europe, we believe issues in the mining and retail sectors are the most likely to become fallen angels.

While certain downgraded bonds will continue to struggle following their transition to the high yield universe, others may present opportunities to add value. In fact, the fallen angel component of the high yield market has often posted strong total and risk-adjusted returns, attributable to three factors: 1) the bonds often enter the high yield universe at relatively distressed prices following forced selling by high quality investors; 2) issuers are typically larger, diversified entities with more levers to pull to generate liquidity and fend off bankruptcy; and 3) larger companies once rated investment grade often have a strong desire to return to investment grade status to ensure continuous access to the capital markets.

Fallen Angels Could Double U.S. Energy Exposure (%)



Sources: PGIM Fixed Income and Bank of America Merrill Lynch as of February 8, 2016.

Cross-Border Relative Value

High yield investors may also capitalize on the globalising cross-border relative value opportunity set. Increasingly, large companies are issuing bonds in both the U.S. and European high yield markets to take advantage of different market conditions, yields, spreads, and liquidity profiles. These differences, along with the market's degree of familiarity with certain credits, can lead to significant spread discrepancies for issues with essentially the same risk and duration exposures. Investors can potentially benefit by purchasing the more attractive bond in either U.S. dollars or euros, and hedging the currency risk.

At times, investors can also add return by exploiting inefficiencies in the cross-currency asset swap market. Today, an investor can potentially pick up nearly 40 bps of spread by purchasing a euro issue and hedging it back to U.S. dollars.

On a cautionary note, investors should still expect a few twists and turns this year due to global growth concerns, geopolitical risks, shifting investor sentiment, and fallen angels. Active management and strong research capabilities with 'boots on the ground' will be key to identifying value and price dislocations across regions, industries, quality tiers, currencies, and bonds within an issuer's capital structure.

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