2020 Fixed Income Market Outlook: Blurred Lines

Dave Albrycht, CFA, President and Chief Investment Officer

In July of 1985, Ray Allen was celebrating his 10th birthday, practicing what many at the time considered somewhat of a novelty, 3-point shots. The NBA had just recently debuted the 3-point line in the 1979-80 season, which garnered limited initial acceptance. That season, teams averaged less than three 3-point attempts per game. Red Auerbach was quoted in the New York Times saying, "We don't need it. I say leave our game alone."

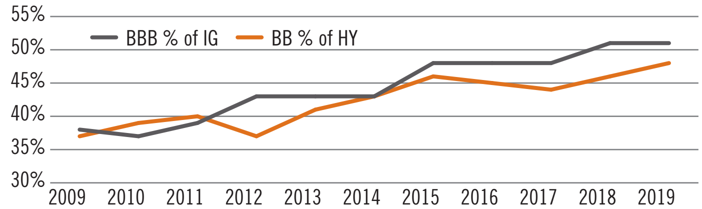
By the time Ray was drafted in 1996, teams were now averaging 15 3-point attempts. The game was changing. By 2014, the average rose to 22 attempts, and Ray Allen retired a 10x NBA All-Star, boasting 2,973 career 3-pointers. Ray was successful not only because he was such a great 3-point shooter, but because he cultivated a skill that became increasingly relevant as the game evolved.

I am particularly excited for 2020. Not because I'm extremely favorable on current macro conditions, as our Outlook will highlight, but because our investment approach has become increasingly valuable in this environment. Newfleet's core competency has always resided in our ability to leverage expertise across the different sectors within fixed income, and we are one of the few multi-sector firms that has done so successfully over multiple decades, through various credit cycles and interest rate regimes. Today, the distinction between credit markets has grown increasingly blurry, and our experience investing across and within these sectors has never been more relevant. The game is changing.

Consider, for example, the convergence taking place in the corporate bond universe:

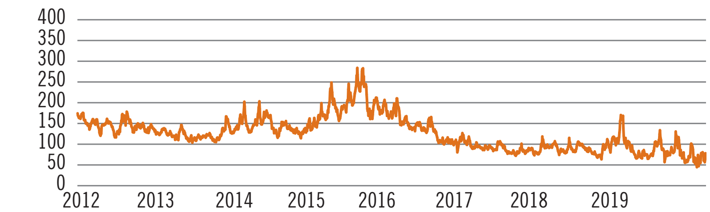
- The investment grade (IG) market was 38% BBB rated at the start of the decade—today it is 51% and growing.
- The high yield (HY) market was 37% BB rated at the start of the decade—today it is 48% and growing.
- Currently, 50% of the combined IG and HY markets are either BBB or BB rated versus 37% in 2009.
- In 2019, the relationship between spreads for BBB and BB credits hit a decade low.
- There are high levels of issuance of secured bonds (with IG ratings) from HY issuers.

BBB AND BB BONDS ARE A GROWING PERCENTAGE OF THE MARKET



Source: Bloomberg L.P.

BB-BBB SPREAD DIFFERENTIAL



Source: Bloomberg L.P.

Similarly, consider aspects of the convergence between the HY and leveraged bank loan sectors:

- There is a meaningful overlap between HY and leveraged loan issuers, roughly 48% by index weight.
- Approximately 80% of loans are now covenant lite (a bond characteristic), while secured issuance (a loan characteristic) from HY borrowers has surged to roughly 18% of index market value.
- The yield differential between the two asset classes is near decade lows.

GAP BETWEEN S&P/LSTA LEVERAGED LOAN INDEX AND BAML HY INDEX

Source: LCD, an offering of S&P Global Market Intelligence

For a comprehensive analysis of the convergence between HY and leveraged loans, see Newfleet's Market Convergence and the Case for a Flexible Approach to Leveraged Finance.

I have confidence in Newfleet's ability to utilize its broad skillset to capitalize on a market that is moving in our direction. We will continue to improve upon what we do best and I look forward to our partnership in 2020.

Executive Summary

Investors will continue to face uncertainties in 2020 as geopolitical risks can emerge at any moment. The ebb and flow of the continuing saga of U.S.-China trade negotiations can whipsaw markets. 2019 has witnessed an abrupt about-face from global central banks that has led to risk assets generally outperforming for the year. Heading into 2020, Newfleet believes that fixed income spread sectors will continue to offer better value than U.S. Treasuries and other government-related debt.

Newfleet currently has an "up-in-quality" bias across portfolios given our neutral macro outlook. However, sources for alpha generation have increased in two critical ways. First, the convergence of several asset classes allows for more opportunities for Newfleet to do what it does best—exploit inefficiencies and take advantage of dislocations. Second, within individual asset classes, credit selection was a major driver of performance in 2019, a trend we expect to continue in 2020.

GLOBAL MACRO EXPECTATIONS FOR 2020

- Overall: Neutral
- U.S. Treasury rates and credit spreads will remain range bound following the YTD 2019 rally in both; we expect both to remain at the tighter end of recent ranges for 2020:
  - We believe that the continued absence of inflation, asset purchases from global central banks, and high sensitivity of the U.S. economy to financing costs will prevent government bond yields from rising meaningfully.
  - We expect the slowdown in global growth to keep central banks with an easing bias, but not to be so slow as to cause equity markets to come under sustained pressure, which would push credit risk spreads wider.
- The tone for credit markets will be set by global central bank activity, economic trajectory, and corporate earnings. We expect further central bank easing to counterbalance, but not fully offset, changes in growth and any earnings weakness.
- The fundamental question centers on the effectiveness of monetary policy from the world's central banks.

KEY RISKS

- Lower starting points for spreads leave less room for bond prices to absorb unexpected shocks.
- Valuations already factor in some rebound in credit fundamentals.
- Slowing global growth—do we have a recession? How much spills into the U.S. and, within the U.S., does the consumer get hit?
- U.S./China trade war developments.
- Other geopolitical events: Hong Kong, Brexit, Middle East.

ELEMENTS OF OUR BROAD VIEW AS WE ENTER 2020

- The blurring of lines between the investment grade (IG) and high yield (HY) corporate debt markets has created pockets of opportunity. For example, some IG bonds carry coupon steps that automatically increase the coupon in the event of a rating downgrade. Given the limited differential between BB and BBB spreads (see exhibit on page 1), the value of such steps has increased.

- Newfleet expects spread sectors to outperform in 2020 due to their yield advantage as total returns in fixed income markets will come from earning the yield. Despite this view, Newfleet maintains an exposure to below investment grade sectors that is lower than our historical averages due to tight valuations that result in higher quality sectors having superior risk-adjusted return profiles across a range of scenarios.

- "Bifurcation" has emerged as a prominent theme in bank loans in 2019 as higher quality BB rated loans have outperformed relative to lower quality B rated and CCC rated loans. We believe this bifurcation across ratings was largely driven by technical factors—CLO managers' preference to sell ahead or upon downgrades, higher quality loans shrinking in aggregate amount due to refinancings by high yield bond issuance, and M&A-related repayments. Our multi-sector funds can take advantage of these technical dislocations, and as such, we are re-underwriting credits negatively impacted for rotation opportunities.

- Our HY view for 2020 is a continuation of 2019; we continue to favor issuers exposed to the U.S. consumer, which we expect to remain healthy. Commodity-exposed industries will remain underweight relative to the benchmark. We still find value in higher-rated segments of the market despite tight spreads given these are generally more robust businesses and should still benefit from strong demand as investors look for lower-risk ways to boost yields. Important variables to watch will be the actions of central banks; B rated spreads, which, if widening, may be more telling of a change in risk tolerance than the more idiosyncratic/commodity-driven CCC spread level; and lending standards by domestic banks given the importance of the U.S. consumer. Note that while we consider the prospects for bank loans and HY separately, the convergence of the two asset classes, and our capabilities across asset classes, enable us to take advantage of nuances and shifts in their relationship.

- Our overall emerging markets view is neutral, but we continue to add exposure selectively by identifying tradeable themes across both credit rating tiers and region. We maintain our strong dollar view because we believe that higher U.S. growth will attract equity flows, and higher relative rates will attract fixed income inflows. Such flows, combined with muted potential for sustained oil price strength, will continue to support the USD and thus keep our non-USD exposure minimal.

- We are increasing our exposure to the commercial mortgage-backed security (CMBS) space on the margin versus IG corporates given the CMBS total return underperformance versus IG corporates in 2019. We favor one-off asset types such as commercial real estate collateralized loan obligations (CRE CLOs) and small balance commercial deals. Additionally, we like the single-asset-single-borrower (SASB) space. SASB transactions afford us the ability to analyze one property type and invest deeper in the capital structure. We like the SASB senior and subordinate tranches where detailed underwriting analysis is more attainable than multi-loan conduit transactions.

- Residential mortgage-backed securities (RMBS) continues to be an important alpha-generating sector for Newfleet. We expect the technical (supply/demand) environment to remain positive into 2020. Gross issuance is expected to top $125B, which will be the highest issuance since 2007, with net issuance around $30B.

- As always, relative value drives sector allocation decisions and can result in outcomes that may vary from our views above.

—as of December 10, 2019

For the reader who would like more details on our sector outlooks, the following section provides in-depth views by Newfleet's sector specialists on their respective areas of expertise.

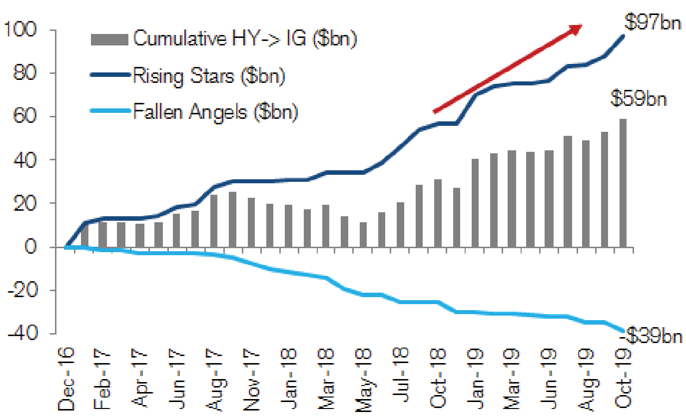
Spread Sector Outlook

INVESTMENT GRADE CORPORATES
By Ryan Jungk, CFA

The IG market is a $6 trillion sandbox. There will always be opportunities for us to uncover, and 2020 will be no exception. While the sandbox is expansive (and growing), the density of opportunities has certainly declined. We began 2019 with spreads above their 10-year averages, yields at a nine-year high, and dollar prices at a 10-year low. We are exiting the year with spreads and yields that are closer to the decade lows than the decade averages. While we are still finding things to buy, we anticipate capitalizing on the relative value relationships between IG and other sectors following a year with 12+% total returns.

Minimizing fallen angel risk will remain a key to outperformance, but requires a nuanced view. We are not shying away from BBB credits, but instead focusing on names with either a) adequate compensation for a potential downgrade, or b) large control over their ratings trajectory. The vast majority of BBB issuers have the flexibility, via high cash flow generation, to manage their leverage through the cycle. We also prefer idiosyncratic situations (M&A) and are shying away from larger capital structures in cyclical industries.

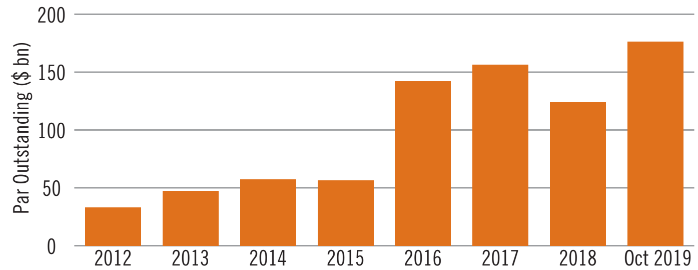
RISING STARS CONTINUE TO OUTPACE FALLEN ANGELS



Source: Credit Suisse

As the lines have blurred between the IG and HY universes, other pockets of opportunity have emerged: 1) issuance of IG-rated secured bonds from HY issuers has grown; 2) several IG companies have issued bonds with yields that were above those of their HY peers, and 3) some IG bonds carry coupon steps that would automatically increase the coupon in the event that ratings are downgraded. Given the limited differential between BB and BBB spreads (see exhibit on page 1), the value of such steps has increased. Given our capabilities across asset classes, we are especially well positioned to identify these opportunities.

TOTAL DEBT OF ISSUERS THAT HAVE BOTH INVESTMENT GRADE AND HIGH YIELD BONDS (OR LOANS)



Source: Bloomberg, Barclays Research

CORPORATE HIGH YIELD
By Eric Hess, CFA

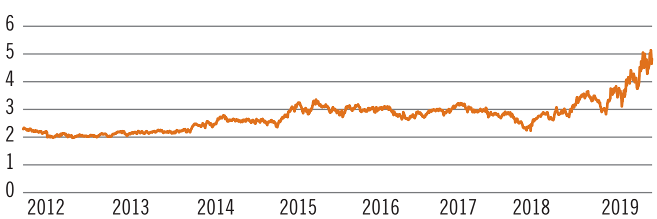
The corporate high yield market has had an excellent year so far in 2019 with double-digit total returns driven by spread tightening and declining risk-free rates. There are three main takeaways from 2019. First, higher-rated issues outperformed lower-rated issues despite the opposite usually happening in risk-on environments where overall spreads tighten. Second, the asset class saw positive fund flows after two years of negative flows. Third, energy massively underperformed other industry groups with negative excess returns.

When evaluating the high yield asset class, we consider three factors: fundamentals, technicals, valuations. Fundamentals will be a headwind to performance in 2020. Credit metrics such as leverage and interest coverage remain stable and are better than trough levels seen in 2016-2017. However, fundamentals have deteriorated throughout 2019 in terms of slowing revenue and earnings growth. The fundamental weakness can also be seen in rating agencies' actions where downgrades are outpacing upgrades. Given most of the macro headwinds remain—trade war headlines, a heated domestic political climate, and mixed global economic data—it seems like this trend will continue. This year also has the overhang of a presidential election with some candidates calling for major structural changes in the U.S. economy. The default rate remains below the long-term average but should move higher throughout 2020 even absent a recession. Energy-related names will continue to see significant defaults with a rate approaching mid-teens.

The technical environment is likely to be a tailwind to performance similar to 2019 where the positive impact from inflows outweighed the jump in supply. Supply should remain heavy for several reasons: 1) the low yields on many bonds have created attractive opportunities for issuers to refinance with lower coupon rates and longer maturities, 2) supply may shift from loans to bonds given CLO investors have limited appetite for lower quality paper, and 3) merger and acquisition related volume is difficult to predict, but large amounts of uncommitted money in private equity funds create a scenario where M&A volumes could be elevated. Fortunately, demand for high yield has been strong and should continue to be so as investors search for yield. U.S. dollar high yield holds a significant yield advantage to most fixed income asset classes. Investment grade bond buyers are likely to continue to shift allocations to higher quality (BB rated) portions of the high yield market to hit yield bogeys.

Valuations look fair with the overall spread level on the index slightly inside the five-year average but wide of the tight levels seen in late 2017 through late 2018. However, it is important to note that looking at spreads on an aggregate index basis can be misleading. BB rated issue spreads are very close to five-year tights while CCC rated issue spreads are wide of the five-year average. This is the result of the strong outperformance by BB rated bonds over CCC rated bonds, which has driven the spread ratio between CCC and BB rated bonds considerably higher. Despite the widening of spreads on CCC rated bonds, they will still significantly underperform in a risk-off environment.

CCC/BB SPREAD RATIO



Source: Bloomberg, Barclays Research

Perhaps unsurprising given the strong performance in 2019, expectations for 2020 returns are more muted. We expect returns consistent with clipping coupons for a mid-single-digit percent return. Given the starting spread level of near 390 basis points, spreads could see some tightening in 2020, which would drive returns higher. However, to see a material compression in spreads will require participation of CCC rated bonds, an event we perceive as unlikely. Absent a significant improvement in economic data, we expect CCC rated bonds to largely remain out of favor as recession fears remain top of mind for investors given the length of the current economic expansion. In addition, large parts of the CCC index remain challenged with idiosyncratic issues. Specifically, oil and gas firms face an oversupplied market driven by technology, healthcare firms face regulatory headwinds, and retailers and telecom issuers face secular declines.

Our strategy for 2020 is a continuation of 2019 where we retain significant allocations to firms exposed to the U.S. consumer, which we expect to remain healthy. Commodity-exposed industries will remain underweight relative to the benchmark. When looking at ratings, we still find value in higher-rated parts of the market despite tight spreads given these are generally more robust businesses and should still benefit from strong demand as investors look for lower-risk ways to boost yields. While we will remain highly selective in regards to CCC rated securities, as in the aggregate we view them as offering poor risk-adjusted returns, we are not abandoning the space. When investing in lower-rated issuers, we generally prefer a catalyst for performance improvement beyond a simple economic rebound. Important variables to watch will be the actions of central banks, which have been supportive of the asset class; B rated spreads, which if widening may be more telling of a change in risk tolerance than the more idiosyncratic/commodity-driven CCC spread level; and lending standards by domestic banks given the importance of the U.S. consumer in the current economic environment.

BANK LOANS

By Frank Ossino

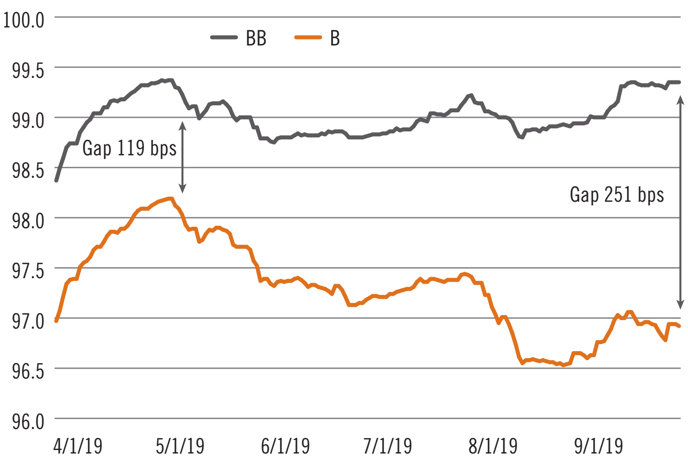
On the back of still supportive, albeit decelerating, macroeconomic conditions and a pivot toward a lower interest rate regime in the U.S., 2019 was a good year for risk assets and fixed income in general, especially long duration markets. Despite a declining rate environment, the loan market will close 2019 up nearly 8%, driven largely by coupon. Our return expectations for 2020 are for another coupon-driven year.

Looking ahead to 2020, we remain constructive on the loan market, but recognize that credit selection will be the path to outperformance. Financial markets appear to be less concerned about recession compared to this time in late 2018. With the data pointing to continued low inflation, central bank accommodation, and GDP growth in the 2% area, the year could extend the long post-crisis recovery and set up nicely for risk assets, including loans. A very manageable maturity wall and strong interest coverage metrics round out our positive view, but not without concerns. Alongside the unresolved U.S./China trade issues, credit conditions have deteriorated to some degree as evidenced by an uptick in loans trading below 80 cents on the dollar and a spike in credit agency downgrades that have increased the size of the B- and CCC rating cohorts.

In terms of demand, the Fed pivot to a rate cut path in 2019 resulted in consistent monthly redemptions from retail funds. Absent a rising rate environment in 2020, our expectation is that retail loan investors—now only 12% of the market—will continue to sell the asset class, but perhaps at a more tapered pace. Conversely, we expect collateralized loan obligation (CLO) issuance in 2020 to be in a range similar to 2019 (around $100 billion) as institutional investors—domestic and foreign alike—gravitate toward the attractive long-term, risk-adjusted return profile of the loan market and the benefits the CLO wrapper afford for such exposure. Regarding supply, issuance was down roughly 30% in 2019 due to limited M&A opportunities, but also a result of market share loss as borrowers elected to finance themselves through the high yield market where overall demand was more robust. Much of the loan issuance was to refinance existing loans. All else equal, we expect issuance to remain muted in 2020, as refinancings slow but also as high yield continues to take share in a range-bound interest rate environment.

Bifurcation was a major buzzword in loans in 2019 due to multiple factors. While lower-tier credit was widening due to credit downgrades and their impact on CLO structures, investors favored the higher quality cohort at a time when high yield bond issuance increased and was used to repay quality loans; in essence, coupled with M&A-related repayments, this part of the market shrank. The current widening credit bifurcation could create rotation opportunities.

WEIGHTED AVERAGE BID PRICE OF BB AND B RATED LOANS



Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index

Many of the domestic and global hotspots in 2019 will carry into 2020. For the loan market specifically, recent late cycle behavior is now beginning to manifest itself as borrowers miss expectations and are subsequently downgraded by the credit rating agencies. The recent spike in the downgrade/upgrade ratio is the highest reading in a decade. Roughly 60% of the 2016 issuance vintage has missed expectations by an average of 30%. Credit downgrades may impact CLO structures as they manage to certain risk parameters embedded within the portfolios, resulting in violent downward price movements. Loose terms and conditions may impact future recovery rates. While negative price movements—defined here as loans below 80 cents—have largely been idiosyncratic thus far, these factors taken together could negatively impact loans more broadly as the market reprices these risks.

As to implementation, we have reviewed our lower tier exposure for signs of downgrade risk and have selectively reduced holdings to get ahead of earnings misses, or sell-offs created by CLO technicals tied to credit agency downgrades. The continued widening credit bifurcation is increasingly creating rotation opportunities. As such, we are beginning to re-underwrite credits that have been negatively impacted and looking for opportunities to add in an effort to take advantage of valuations created by technical dislocations.

For more detail on the prospects for this asset class and our forecast, see Newfleet's 2020 Bank Loan Market Update.

ASSET-BACKED SECURITIES (ABS)

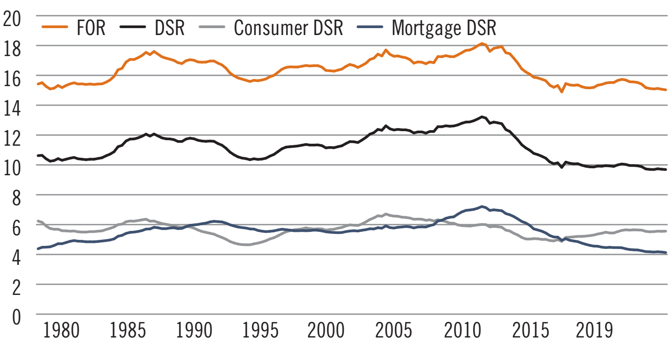
By Nick Rinaldi

Regardless of the fixed income sector, if investors had assets in long duration and credit in 2019, then they were rewarded with very solid total returns. The U.S. Treasury curve rallied 85-90 basis points and the majority of fixed income credit sectors tightened on a spread basis versus the risk-free rate. Within the ABS sector, spreads were marginally tighter for the senior parts of the capital structure in 2019, whereas spreads widened for most subordinate or higher-yielding ABS sectors. Given the short duration nature of ABS, the asset class as a whole outperformed its risk-free counterparts. However, certain sub-sectors within the ABS sector did underperform their risk-free counterparts namely aircraft, container, and railcar-backed transactions. Our overweights to subordinate subprime auto, timeshare, consumer, and whole business transactions proved to be fruitful in 2019.

Unemployment rates near historic lows and consumer confidence near an all-time high has enabled U.S. consumers to perform well on their debt obligations. Also, looking forward, the low interest rate environment provides a positive backdrop with respect to refinance opportunities and also for borrowing at near record-low rates. As the graph depicts below, the financial obligation and consumer debt service ratios (DSRs) also point to consumers who can service their debt easier than they have historically. Note that the mortgage DSRs are at the lowest levels in almost 40 years. This is one of the reasons, as we discuss in our non-agency outlook below, why we have increased our exposure to the non-agency mortgage space.

As we look forward to 2020, we continue to invest in the one-off ABS sectors as we are in the camp that those sectors provide us with the best risk-return tradeoff. During 2019, we continued to invest our book of business on the higher quality part of the capital structure, and we are positioned to take advantage of wider spreads down the road driven by either a technical or fundamental dislocation. As per the Bloomberg Barclays U.S. Aggregate Bond Index (Aggregate Index), the ABS component will return close to 4.50% for 2019, which is an excellent return for a short duration asset. Given the current low yield environment, the ABS sector will be hard pressed to generate a 3% total return for 2020.

CONSUMER DEBT SERVICE RATIOS



Source: Federal Reserve Board. Financial Obligations Ratio (FOR) – Household debt payments to total disposable income. Includes rent payments, auto lease payments, homeowner's insurance, and property tax payments. Debt Service Obligation (DSR) – Combination of mortgage and consumer debt service payments.

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)
By Nick Rinaldi

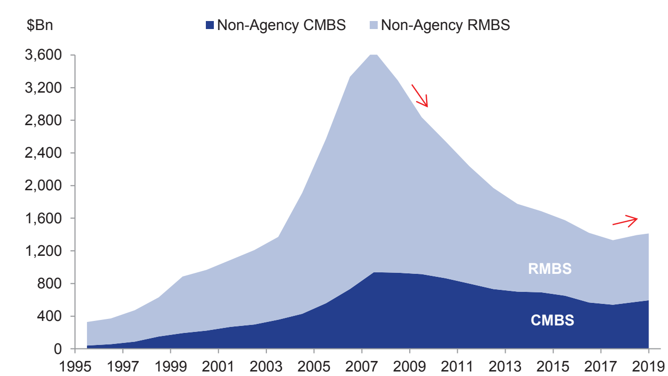
As of this writing, CMBS conduit paper is trading very near its 52-week averages. Akin to most other fixed income sectors, deeper credit outperformed higher-rated credit. During 2019, we maintained an underweight in the CMBS sector versus our historical averages in favor of investment grade corporates. Per the Aggregate Index, investment grade corporates have returned 14.2% versus 8.6% for the CMBS component of the Index (as of 11/30/19). Similar to last year at this time, real estate fundamentals continue to remain positive, albeit property net operating income growth on a year-over-year basis has slowed to low single digits. Commercial real estate (CRE) valuations continued to appreciate during the year as evidenced by the Real Capital Analytics National All-Property Index (RCA CPPI), which increased 6.91% year to date through October 31. As we head into next year, the backdrop for commercial real estate still looks positive as evidenced by managed supply growth, conservative underwriting, and a low Treasury rate environment that makes CRE cap rates look attractive.

Looking ahead to 2020, we are increasing our exposure to the CMBS space on the margin versus investment grade corporates given the CMBS total return underperformance versus investment grade corporates. Given the flat credit curve within the CMBS sector, we are of the ilk that you are not getting paid to go down deep in the capital stack of these transactions. We continue to search for one-off asset types such as commercial real estate collateralized loan obligations (CRE CLOs) and small balance commercial deals. We continue to invest in the single-asset-single-borrower (SASB) space. SASB transactions afford us the ability to analyze one property type and invest deeper in the capital structure. We like the SASB senior and subordinate tranches where detailed underwriting analysis is more attainable than multi-loan conduit transactions.

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)
By Andrew Szabo, CFA

Since the financial crisis, the amount of U.S. non-agency securitized debt outstanding contracted as issuance volumes ran below the volume of loans running off due to loan maturity, prepayment, or default. In recent quarters, though, non-agency RMBS debt outstanding has begun expanding again based on growing issuance of traditional products such as jumbo prime RMBS and less traditional products such as reperforming RMBS and non-qualified mortgage RMBS.

NON-AGENCY RMBS AND CMBS DEBT OUTSTANDING IS SLOWLY EXPANDING



Source: Bloomberg, SIFMA, Goldman Sachs Global Investment Research

The growth of supply is a positive development. Shrinking supply during 2008-2018 was arguably constructive for spreads but the trend was challenging for portfolio managers needing to replace runoff. The recent growth in debt outstanding has been prudent and not so rapid as to drive spreads significantly wider, as demand has so far matched supply. We expect this to extend into 2020, with net supply again moderately positive for the year. Spreads for RMBS bonds are currently wide versus spreads for corporate bonds of comparable maturity, so we expect demand for new issue RMBS products to be relatively healthy in 2020.

RMBS continues to be an important alpha-generating sector for Newfleet. We expect the technical (supply/demand) environment to remain positive into 2020. Gross issuance is expected to top $125B, which will be the highest issuance since 2007, with net issuance around $30B.

Fundamentals remain positive though the housing market is slowing. 2020 market forecasts are for low single-digit growth on the national indices. While the housing market has slowed from the rapid growth over the past few years, we believe better affordability amid the low rate environment and continued supply/demand mismatch should keep home price appreciation (HPA) stable, especially in lower price tiers.

Mortgage credit remains very strong as underwriting standards loosen, albeit at a gradual pace but still conservative compared to pre-2008. Mortgage payment delinquencies remain at all-time lows given the backdrop of a strong economy and the stronger financial condition of the consumer as mentioned above.

AGENCY MORTGAGE-BACKED SECURITIES (MBS)

By Andrew Szabo, CFA

2019 was an eventful year for agency MBS. Mortgage rates rallied 100 basis points and, in turn, we saw 30-year Fannie prepays increase from a 6% conditional prepayment rate (CPR) in January to a 21% CPR in October. Rate volatility is never good for MBS. Given the rate rally, MBS total returns were 6.06% through 11/30/19, the highest since 2014 but they still underperformed more cyclical asset classes such as investment grade corporate credit, which was up 14.2% through 11/30/2019. 2019's global macro and trade uncertainties will carry over into 2020.

As we enter 2020, the forecast supply of MBS is expected to be robust as we begin the year with low mortgage rates, good housing activity, and the Fed continuing to reduce its MBS portfolio. The onus will be on money managers to reallocate from corporates in the 11th year of this economic expansion and play a bigger role in the MBS market along with banks, overseas investors, and REITs.

Current valuations of MBS are favorable to U.S. Treasuries and investment grade corporate credit. MBS spread to U.S. Treasuries are 10 basis points wide to three-year averages. We also expect a modest shift by investors from investment grade credit bonds into MBS as relative value appears favorable setting up for a positive and range-bound 2020.

Currently, we are approaching 2020 in the same manner as 2019 when it comes to our residential MBS portfolios. We believe that non-agency RMBS and residential mortgage credit offer some of the best opportunities in the fixed income market. Agency MBS can offer some value but it is one of the most efficient markets within the fixed income universe, hence difficult to find market-beating values. Residential credit is still in the early innings and we feel there are alpha advantages to be found for our portfolios and versus our peers.

EMERGING MARKETS & NON-U.S. DOLLAR-DENOMINATED BONDS

By Peter Lannigan, CFA, and Daniel Senecal, CFA

Opportunities with the Sector

We continue to add emerging markets (EM) debt exposure selectively. Our overall EM view remains neutral, which is in line with our neutral view of the global macro backdrop. Such a setting provides sufficient stability for us to capture value by identifying tradeable themes, including:

By Credit Rating

Our portfolios have had, and continue to have, more investment grade (IG) EM debt than high yield (HY) EM debt. Most market participants eschewed IG EM debt, claiming that spreads were too tight. They were wrong. IG EM has generated 2.5x the total return of HY EM this year; the differential is still high at 2.3x when we exclude Argentina from the calculation. Our counter-consensus strategy centered on seeking pockets of value in countries with both incremental spread over comparable U.S. spread sectors and improving country fundamentals. We continue to see opportunities in countries with valuation discounts emanating from headline political risk, but with economic fundamentals that provide a more than adequate offset. Some examples:

- Mexican debt is up 18.9% as the AMLO administration has been much more market friendly than the market anticipated. This includes government support for PEMEX, the state-owned oil company. Note: all performance numbers referenced are of the JP Morgan EMBI Global Index (EMBIG) as of 11/30/19.
- Indonesian debt is up 17.5% as the country's credit risk profile continues to improve on all fronts under the second Jokowi administration.

By Region

- Within the Commonwealth of Independent States, Russian debt is up 20.1%. Despite headline political risk, investors have focused more on the country's large fiscal and balance of payments surpluses, which have resulted in a very low debt burden and large holdings of liquid USD-denominated financial assets. Kazakhstan's debt is up 20.8% as fiscal performance has improved and energy export revenues have been managed prudently. Ukraine's 27.2% rally has been driven by lower political risk, especially by improved relations with the international financial institutions (the IMF, in particular). Further meaningful progress has been made in securing external credit on concessionary terms as the country's progress in pursuing economic forms has surprised to the upside.
- We use bouts of geopolitically driven market volatility to add exposure to the Middle East. This region has both IG and HY alternatives. Many bonds here have spreads that are wider than what can be justified by country fundamentals.
- We continue to like several countries in Africa. This region has generated a total return of 1.4x that of the overall market and the region's risk spread is still 1.5x that of the EMBIG. Sub-Saharan Africa's bonds generally perform more in line with equities than Treasuries. This attribute provides nice portfolio construction benefits in that it offers good diversification against our more Treasury-sensitive IG EM exposure. Additionally, we have seen a wide range of total return performance by country; from 23.8% for Kenya, where we have an overweight exposure, to -4.0% for Zambia, where we have no exposure. This performance dispersion provides opportunities to add alpha through country selection.

Non-U.S. Dollar

Among the major economic blocs, we still expect the U.S. to be the outperformer and the driver. We are thus retaining our strong USD view because we believe that higher U.S. growth will attract equity inflows, and higher rates will attract fixed income inflows. Such flows, combined with muted potential for sustained oil price strength, will continue to support the USD. This component of our strategy has resulted in minimal non-USD exposure in our portfolios, which has served us well. Despite interest rate rallies in several EM countries, pervasive currency weakness has dampened the overall local market index return, resulting in meaningful underperformance versus the JPM EMBIG hard currency index.

JP MORGAN EM CURRENCY INDEX 12/31/18-12/02/19

Source: Bloomberg L.P.

TAX-EXEMPT MUNICIPAL BONDS

By Tim Heaney, CFA, and Lisa Leonard

As we look ahead to 2020, we are again cautiously optimistic about the tax-exempt bond market. Many of the themes that have dominated the municipal market in 2019 may likely carry over to next year. While municipal bond yields will probably take their lead from the U.S. Treasury market, the strong technicals and solid fundamentals should continue. While valuations appear on the richer side, individuals who can benefit from the tax exemption of municipal bonds may see value once municipal yields are calculated on a taxable-equivalent basis, which should benefit the demand for this asset class. With 2019 being a year of exceptional demand, as evidenced by the record-breaking inflows into tax-exempt bond funds, it is difficult to imagine that this trend can maintain its current pace. But, with the upcoming presidential election and political debates that will intensify, voters will be more keenly focused on the topic of taxation. Should the current Democratic nominee front runners' tax policy plans be enacted, they could greatly impact demand for tax-exempt income. In addition, with the general consensus that lower rates will persist for the near term, particularly when looking at low global interest rates, demand for municipals can continue even at these lower yields.

While we will continue to focus on the longstanding challenge of underfunded pensions and growing climate change issues, municipalities have benefited from this country's extended economic expansion with growing tax revenues. While tax revenues are expected to slow in 2020, most municipalities have exercised fiscal austerity, have rebuilt their reserves, and appear in better financial shape should the economy begin to show signs of weakening. An increase in credit impairments by riskier borrowers is one potential concern that has arisen as a result of low interest rates, easy access to the capital markets for lower quality issuers, and fierce demand for yield by investors willing to accept more marginal credits. We believe that now is not the right time to take on additional credit risk in the municipal market, especially with credit spreads at historically tight levels. Despite this concern, we believe that municipal bonds remain one of the lowest-risk asset classes with credit metrics for the majority of municipalities continuing to improve.

For more information about Newfleet's fixed income strategies, please contact:

Bill Irvine, Senior Managing Director, Institutional Business Development, Newfleet Asset Management
T: 860.760.5832 | C: 781.329.9283 | William.Irvine@Newfleet.com
www.Newfleet.com

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt securities are subject to various risks, the most prominent of which are credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt securities may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **High Yield-High Risk Fixed Income Securities:** There is a greater level of credit risk and price volatility involved with high yield securities than investment grade securities. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the repayment of underlying collateral. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk. **Municipal Market:** Events negatively impacting a municipal security, or the municipal bond market in general, may cause the fund to decrease in value. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans can carry significant credit and call risk, can be difficult to value and have longer settlement times than other investments, which can make loans relatively illiquid at times.

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The **Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The index is calculated on a total return basis, is unmanaged and not available for direct investment. The unmanaged index returns do not reflect any fees, expenses, or sales charges. The **Bloomberg Barclays U.S. Intermediate Aggregate Bond Index** measures securities in the intermediate maturity range of the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **S&P/LSTA Leveraged Loan Index** is a daily total return index that uses LSTA/ LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. The **ICE BofAML US High Yield Index (HOAO)** tracks the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have a below investment grade rating. Original issue zero coupon bonds, 144a securities, both with and without registration rights, and pay-in-kind securities, including toggle notes, qualify for inclusion. Eurodollar bonds, taxable and tax-exempt U.S. municipal, warrant-bearing, DRD-eligible and defaulted securities are excluded from the Index. The indexes are calculated on a total return basis with net dividends (and capital gains if applicable) reinvested. The **JP Morgan Emerging Market Currency Index (EMCI)** is a tradable benchmark for emerging markets currencies versus the U.S. Dollar. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges and they are not available for direct investment. **LIBOR:** London Interbank Offered Rate.

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