2Q 19 | VIRTUS VIEWPOINTS

MARKET REVIEW AND OUTLOOK

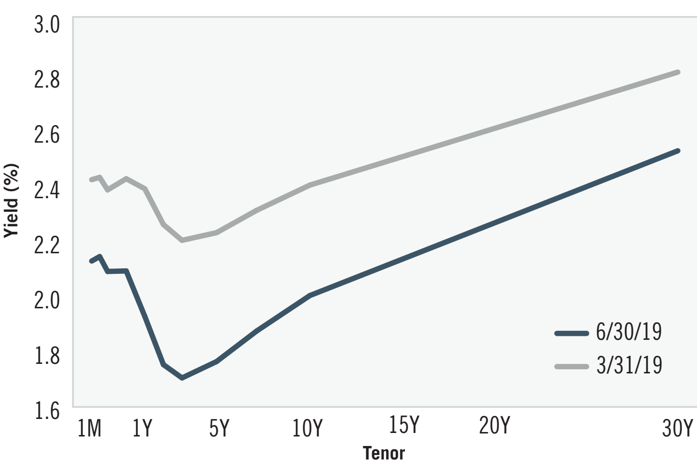
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Fixed income market performance continues to be dominated by a mixture of geopolitical posturing (specifically the use of tariffs as a policy tool), weaker economic data, and central bank headlines. Broader market fundamentals, technicals, and valuations still matter, but are frequently overshadowed by the aforementioned in the current environment. The theme of the dovish central banks' turn remains in place with market confidence growing that policy easing is forthcoming. This significant development in the markets, when combined with improved valuations, has led to a return to favor of risk assets.

Oil price volatility has returned despite ongoing production curtailments from OPEC as fears over the outlook for demand have resurfaced and the U.S. dollar has weakened. The U.S. Treasury curve continues to twist and shift broadly flatter and lower with some segments of the curve remaining inverted. We believe that this change in the curve is more indicative of technical factors in the market than of a looming U.S. recession, and we will continue to monitor the incoming economic data to form our opinion.

As expected, the FOMC (Federal Open Market Committee) kept its target rate unchanged in a range of 2.25-2.50%. While keeping rates steady in June, the Chair of the FOMC indicated the decision-making body is monitoring the impact of the tariff issues on the U.S. economic outlook. The market interpreted these comments as a sign that the FOMC has opened the door to the rate cut discussion.

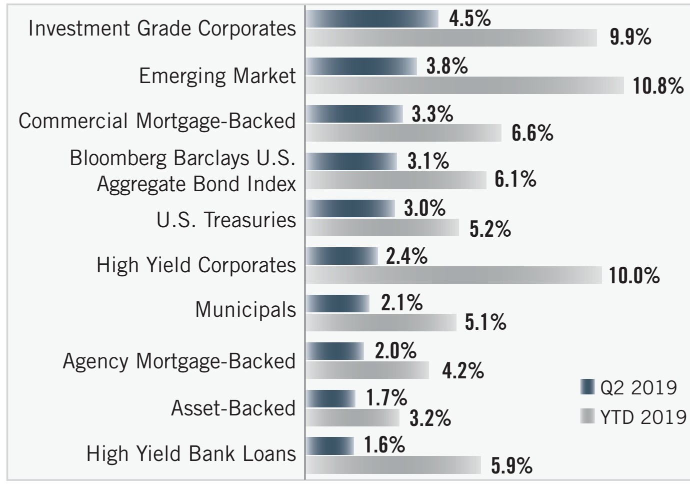
U.S. TREASURY YIELD CURVE



Source: Bloomberg L.P.

Spread sectors performed well during the quarter led by corporate high quality, emerging markets high yield, and corporate high yield. Given the change in U.S. interest rates, longer duration within most asset classes outperformed on a total return basis. Securitized sectors (asset-backed securities (ABS) and non-agency residential mortgage-backed securities (RMBS)), while still positive, lagged other sectors.

FIXED INCOME SECTOR PERFORMANCE



Performance as of June 30, 2019.
Sources: J.P. Morgan: Emerging Markets (EMBI Global), High Yield Corporates, High Yield Bank Loans; Bloomberg Barclays Municipal Bond Index: Municipals; Bloomberg Barclays U.S. Aggregate Bond Index: All other sectors.
Past performance is no guarantee of future results.

We continue to see value in spread sectors. The dovish turn by central bankers, benign consumer, housing, and corporate fundamentals, as well as the global demand for yield, continue to underpin our strategy.

The following sections reflect the views of the individual sector specialists.

INVESTMENT GRADE CORPORATES

Total returns were an eye-watering 9.85% in the first half of 2019, following a 4.48% return in the second quarter. If total returns in the second half of the year are even half the level of the first six months, we will have set a new record low for corporate yields. We believe this is realistic, and even probable.

The decline in yields is remarkable. Investment grade corporate yields were at a nine-year high in November of 2018, but declined 121 bps (28%) to 3.16% in the following seven months. Yields declined 47 bps during the second quarter with spread tightening accounting for just four bps of the change. Ignoring the trend and looking at a snapshot of the data, we see that yields are currently 15 bps below the post-crisis average and 58 bps above the all-time low (April 2013). Yields tested the 2.75% level in 2014, 2015, and 2016, but did not break through. In light of our economic and technical outlooks, we believe spreads will likely challenge that level again in 2019.

Net supply in the second quarter was $8 billion higher year over year (yoy) at $68 billion, while year-to-date net supply is still running 9% below last year's pace. Recall that net supply in 2018 was down 50% from the 2016 peak of $682 billion; we are thus comparing yoy supply to the lightest supply year since

2007. When yields hit their all-time lows in 2013, net supply was $670 million in both 2012 and 2013. We expect net supply to be less than half that level in 2018-2019. A large driver of net supply has been M&A where the forward calendar is at the lower end of its five-year range.

U.S. CORPORATE INVESTMENT GRADE – YIELD TO WORST
June 2018 – June 2019

Source: Bloomberg L.P.

Meanwhile, demand has been robust and likely to increase from this point. Mutual fund flows year to date are over $100 billion, more than double 2018's level. Foreign flows are likely to increase as the level of negative-yielding debt worldwide is at a record high and rising ($13 trillion). There is renewed potential for another round of European Central Bank bond-buying, which would likely push potential buyers across the Atlantic.

Spreads have room to compress as they ended the second quarter at 116 bps, within 10 bps of the five-year average. Fundamentals are deteriorating slightly as earnings growth has slowed (+1% in Q2). However, with strong free cash flow profiles and low funding costs, we do not believe fundamentals present a near-term obstacle for incremental investors at this stage.

HIGH YIELD CORPORATES

The corporate high yield sector continued to perform well post the late-2018 selloff as investors remained comfortable with credit risk and, more importantly, willing to take on duration. Following weak performance in May (the first negative month of 2019), enthusiasm for high yield regained its strength in June as the Fed hinted that rate cuts were forthcoming, and U.S./China trade tensions at least temporarily abated.

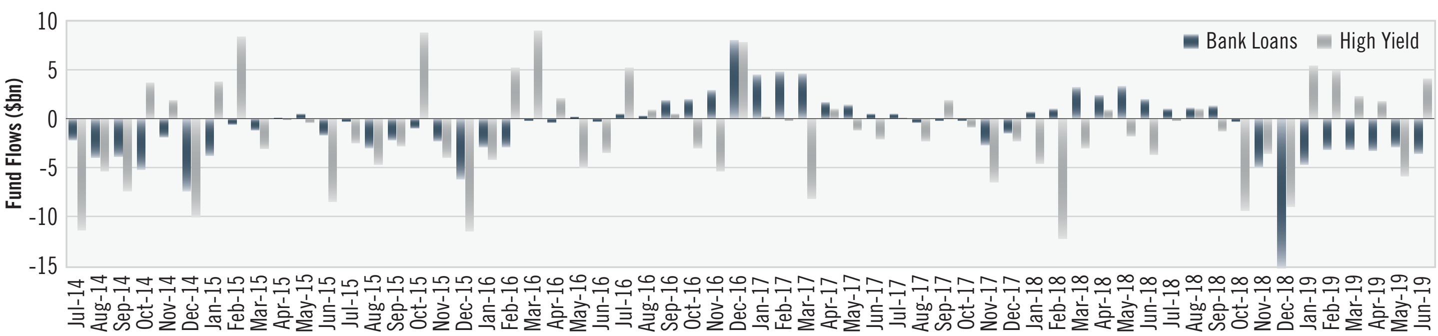
While investors were looking to add yield, they were not necessarily willing to chase riskier investments, as evidenced by the credit quality returns of BBs (+3.08%), Bs (+2.4%), and CCCs (+0.34%). The willingness to take on duration was more apparent with the longer end of the high yield curve handily outperforming the shorter end.

Industry returns for the quarter were mostly positive. The enduring strength of the consumer was reflected in such industries as supermarkets (+5.35%), retail (+4.34%), gaming (+3.93%), and restaurants (+3.74%). Tied in with lower interest rates, home construction (+4.54%) and building materials (+3.75%) also performed well. The communications space, a large component of the high yield market, also generated strong results from wireless (+4.71%) and cable-satellite (+3.56%). Other areas of outperformance included banking (+4.64%) and finance companies (+4.12%). Underperforming industries were primarily limited to the energy complex, led down by oil field services (-4.37%) and independent energy (-2.05%). Outside of energy, the only other negative return was in retail REITS (-1.47%).

Fund flows were modestly negative for the quarter (-$0.6 billion) due to a bout of risk aversion in May that led retail investors to shy away from the high yield market. With June's favorable reversal in flows (+$3.5 billion), five of the first six months of 2019 have now seen positive flows bringing the year-to-date total to $12.2 billion. Gross new issuance for the second quarter was $75.2 billion, boosted by June's robust $28.5 billion. The continued presence of a supply deficit provides a solid technical underpinning to the market aided by inflows as well as the large volume of rising stars ($31.9 billion YTD). As of the end of June, the high yield market sits at an impressive supply deficit of $54.5 billion compared to $88.8 billion for all of 2018.

Fundamentals for the high yield issuer universe are still relatively healthy, though slowing, with favorable leverage and interest coverage levels. All eyes are on the current and next few earnings seasons as a lot of companies have baked in stronger growth in

MUTUAL FUND FLOWS



Source: J.P. Morgan, Lipper FMI.

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the second half of the year. The default environment remains benign. June's issuer-weighted default rate ticked up to 3.0% (from 2.4% at end March), largely the result of the oil & gas sector. Moody's forecasts the default rate to be relatively consistent moving forward at 3.2% by year end and 2.9% by June 2020. In terms of ratings momentum, the rating agencies have been more aggressive in downgrading than in upgrading issuers. The second quarter upgrade/downgrade ratio was 0.9x by number of issuers and 0.7x on a dollar volume basis. The respective year-to-date numbers are 0.7x and 0.9x, compared to 1.3X on both an issuer and dollar volume basis for all of 2018.

From a spread perspective, the high yield index ended the second quarter at 377 bps, 14 bps tighter than at the end of the first quarter (391 bps). Yield to worse declined over the three-month period from 6.43% to 5.87%, close to a 12-month tight. Lastly, the average price of the index rose from 97.9 to 99.46.

Alongside our still-favorable view on high yield fundamentals and technicals, valuations remain our overriding concern. We still believe that high yield has the potential to grind yet tighter, but there is limited total return potential with the market up close to 10% at mid year. Still, with the global market awash with negative-yielding instruments, high yield remains a sound alternative for investors to find yield. There is still a lot to be cautious about, from flare-ups in geopolitical risk to whether the Fed modifies its course away from market expectations. If the economy stays in the 2% GDP growth area with little to no inflation, risk markets will benefit. With most of the easier opportunities already picked over in high yield, and idiosyncratic risk so high, correct industry calls and issue selection are imperative for outperforming in the space, particularly at this later stage of the current credit cycle.

BANK LOANS

The bank loan market posted a positive return in the second quarter, but underperformed other spread sectors. Year to date, bank loans have more than recouped the losses of 4Q19.

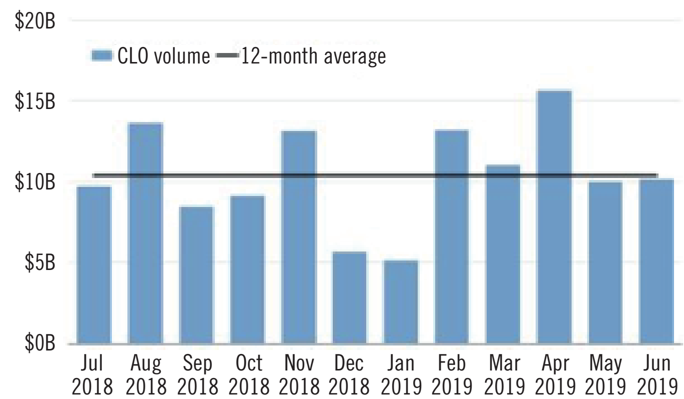
The second quarter of 2019 was essentially a continuation of the first quarter in which the market recognized the technical dislocation of the late-2018 sell off and quickly bought into the loan market at attractive prices and yields. As the quarter progressed, however, continued trade/tariff concerns and their impact on slowing global growth reached a level that has made the Fed increasingly more dovish. As market expectations have shifted from a rate-hike to a potentially rate-cut environment, the bank loan asset class has lost its attractiveness to the retail investor. To a large extent, loans have taken a back seat to high yield where 2% - 2½% GDP growth with flat/declining rates is a favorable environment for that space.

With one exception, all of the industries within the Index posted positive returns for the quarter. The telecom/broadcasting (+2.70%), utility (+2.13%), telecom/diversified media (+2.10%), and housing (+2.08%) industries led the outperformers. Metals/minerals (-1.62%) was the only industry with a negative return. Other industries at the underperforming end of the return spectrum were energy (0.00%), consumer durables (+0.21%), transportation/shipping (+0.36%), and retail (+0.45%). Larger components of the Index and their returns were information technology (+1.46%), service (+1.93%), healthcare (+1.58%), and financials (+1.67%).

On a credit quality basis, BBs (+1.66%) outperformed Bs (+1.57%) and CCCs (+0.58%), while second liens (+1.88%) did better than first liens (+1.57%).

Retail fund flows continued to be negative throughout the quarter for a streak of 32 weeks. Redemptions of $8.8 billion in the three-month period brought the year-to-date total to $19.9 billion. While the Fed's pivot dulled retail interest in the loan market, institutional demand via collateralized loan obligations (CLOs) remained robust at $35.8 billion for the quarter and $65.1 billion year to date. With the demand for floating rate product out of favor, gross new issuance of $157.7 billion year to date was roughly 68% lower than the mid point of 2018. Though expectations of a Fed pause have adversely affected retail fund flows, solid institutional demand, increased loan repayments via high yield bond issuance and more recently IPOs, and light new issuance have provided an offset and, in turn, a well-balanced technical. We expect loan supply to remain muted as volatility reduces both opportunistic transactions such as refinancings, while the M&A environment stalls due to high equity valuations and broad macro volatility. The retail component of demand is roughly 13% of the market, mitigating the impact of the outflows.

MONTHLY CLO VOLUME



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

Fundamentals for the issuer universe are overall sound, taking into account a favorable macroeconomic backdrop, minimal debt maturities, and strong debt service metrics. While the default rate increased modestly in June, it is still well below historical averages. Given the minimal number of loans trading

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below 80 cents on the dollar, the inventory for defaults is negligible. Offsetting the otherwise favorable fundamental view is the deterioration in underwriting standards and the impact on potential recovery levels when future defaults occur in the more aggressive vintage of new loan transactions.

Loan prices have come under pressure with volatility driven by the Fed's pivot, ending the quarter at an average price of $96.78. More than 50% of the market is now trading over $99. That number was just 3% at the start of 2019 and as high as 68% at the beginning of the second quarter. Despite the price appreciation this year, there is still some remaining value given that through 2017 and the first three quarters of 2018 as high as 80% of the market traded at $99 or better. With a yield to maturity of 6.27%, the loan market represents an attractive opportunity for long-term strategic investors.

Our outlook for bank loans is constructive. From a technical perspective, we expect current trends to persist. Retail demand will likely have a continued bias toward outflows given the Fed's dovish posture and prospect of rate cuts. Though we expect CLO issuance to remain strong, we are cautious on widening credit liability spreads and the adverse impact on market arbitrage. Overall, we think that the market will remain fairly balanced given a light new issuance calendar and loan repayments from other sources.

There are, of course, no shortage of risk-off scenarios as we enter the second half of the year, whether the result of trade/tariff issues, slowing global growth, or geopolitical risk. This may create opportunity for bank loans. Bank loans provide an extra layer of protection by being senior in right of payment and being secured by all assets of the borrower. We believe that an allocation to loans in a spread product allocation makes sense, not just because of the inherent protections but also the need for income. These elements are important as the credit cycle matures, despite the prospect of no further rate hikes.

EMERGING MARKETS DEBT

Emerging markets (EM) debt posted a strong total return of 3.76% in the second quarter, as measured by the JP Morgan EMBI Global Index (US$ sovereign), bringing the year-to-date return to 10.76%. The bulk of the quarterly total return came in June, when EM rallied 3.04% on the back of a 27 bps drop in the Index spread to 366 bps and a continued compression in U.S. Treasury yields reflecting increased expectations for easing central bank monetary policy in the U.S. and Europe.

Some highlights for the quarter:

> EM investment grade bonds returned 4.45%, benefiting from longer duration compared to the EM high yield return of 2.85%.

> Among the top performing countries were Ukraine (+10.18%), South Africa (+6.55%), Russia (+6.05%), Turkey (+5.88%), Brazil (+5.27%), and Ecuador (+5.20%).

> New inclusions into the Middle East regional index also performed strongly including Qatar (+6.98%), the UAE (+5.49%), Saudi Arabia (+5.32%), and Kuwait (+5.29%).

> Among the worst performing countries were Venezuela (-33.16%), Lebanon (+1.41), Argentina (+1.50%), Bahrain (+2.02%), Oman (+2.19%), and Mexico (+2.72%).

Looking forward, we continue to expect solid returns from EM debt in 2H19 driven by its high relative carry. However, the pace of gains is unlikely to match that of the first half of the year as G3 interest rates have rallied to the point where they reflect a lot of bad global economic news and the EM index credit spread is near one-year tights and close to resistance levels that it has been unable to crack.

Renewed Fed and European Central Bank easing should offset deteriorating global growth enough to support EM debt markets and ultimately a resumption of more robust growth. This, combined with low inflation in most EM countries, is fueling more policy accommodation in several large EM central banks, including China, Brazil, Russia, and Indonesia. Fed policy is important for most EM countries because it is very difficult for EM central banks to cut rates when the Fed is hiking as doing so would lead to capital outflows and currency instability. A favorable growth backdrop as a result of policy easing should be buttressed by an eventual trade deal between the U.S. and China, despite all of the attendant political headlines.

Overall, we still expect risk market direction for the rest of 2019 to be determined by the interplay of whether newfound Fed dovishness offsets trade-related drags on growth quickly enough to keep risk markets supported. Geopolitical risks continued to flare up throughout the 1H19 but have abated somewhat as we closed out June with constructive dialogue coming out of the G20 meeting on US/China trade, North Korea, and Turkey.

Key Country and Strategy Highlights

> Argentine debt has rallied recently because confidence is returning. This has been reflected in renewed currency strength that, in turn, has pushed inflation lower. All of these factors, combined with better fiscal performance, have translated into a sharp improvement in the government's popularity creating a virtuous circle ahead of the October presidential election.

> We remain neutral on Brazil's prospects as the potential for a more ambitious pension reform (and quicker passage) is balanced by perpetual political fragmentation/risk in the face of structurally weak growth prospects.

> We continue to view Mexico's risk profile more favorably than the market. However, we are neutral at best on Mexican debt as growth prospects are constrained by our belief that the central bank is likely to maintain its tight monetary policy stance a bit longer to sustain currency stability in the face of the less market-friendly policy prescription of the AMLO administration.

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> In Europe, we remain heavily invested in Russia, Kazakhstan, and Azerbaijan based on fundamental credit strengths.

> We still like Ukraine as the new government continues doing almost everything necessary to satisfy the conditions of the IMF credit facility. This is Ukraine's main source of funding, and compliance with IMF targets is the primary confidence barometer used by the international financial community. The next key signpost will be the formation of a new government after the July 21 Rada (congressional) elections.

> Regionally, when we increased our high yield credit quality weighting, we moved to an overweight in Sub-Saharan Africa (SSA) with exposure to Nigeria, Angola, Kenya, and the Ivory Coast. In addition, we complemented our SSA exposure with positions in Egypt and Morocco in Northern Africa.

> June was the first month of 2019 when local currency EM debt outperformed hard currency debt. US$ strength has started to wane as lower U.S. rates relative to the other G7 countries made the US$ less attractive. This revival of "animal spirits" in EM local debt, combined with high local market yield premiums over US$ denominated yields in some countries has induced us to be on the lookout for select potential opportunities.

SECURITIZED PRODUCT

Securitized product had decent performance from a total return perspective but it was a bit of a mixed bag in terms of excess return. According to the Bloomberg Barclays U.S. Aggregate Bond Index (Aggregate Index), asset-backed (ABS), commercial mortgage-backed (CMBS), and agency mortgage-backed (MBS) securities produced quarterly total returns of 1.67%, 3.28%, and 1.96%, respectively. The U.S. 5- and 10-year Treasuries rallied 47 bps and 40 bps, respectively, which was the primary driver of performance for the above-mentioned sectors. From an excess return perspective, however, the ABS, CMBS, and MBS components of the Aggregate Index returned 38 bps, 8 bps, and -20 bps for the quarter, respectively. MBS underperformed due to the swift rate rally and subsequent thoughts of a refinancing wave.

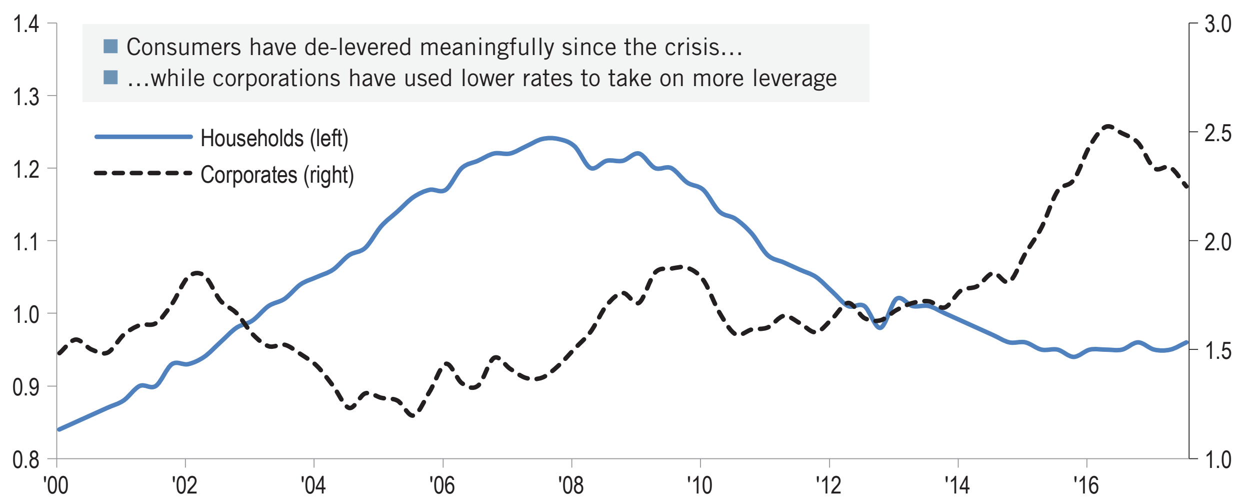
In general, ABS spreads were five to 10 bps wider and CMBS spreads were flat to slightly tighter for the quarter. MBS were six bps wider and RMBS were four bps wider for the period. We continued to witness strong investor demand across all securitized credit asset types as investors' search for yield persists. Strong fixed income mutual fund flows, along with monthly principal pay downs coupled with issuance levels that we would characterize as average within the securitized credit space, have created strong demand for new issue supply.

The combination of low inflation, higher wages, and lower interest rates should improve affordability and contribute to a bounce back in existing home sales this summer. Home prices will continue rising, albeit at a decelerating pace with year-over-year Home Price Appreciation (HPA) slowing to 3-4% by year end. Employed consumers continue to pay their bills and although delinquencies may have trended somewhat higher as of late, the fact of the matter is that this increase is off of all-time lows. We still prefer the U.S. consumer over the U.S. corporation and have continued to increase our portfolio exposures to the former.

The technical picture of forecast issuance for the securitized product sectors is very manageable as issuance should only slightly exceed this past year's supply. Unless fundamentals deteriorate within securitized product, we envision continued strong demand for all asset types.

Within ABS, we still favor the subprime auto, unsecured consumer loans, timeshare, and whole business sectors of the market on a relative value basis versus other sub-components of the asset-backed market. We continue to witness increased issuance of one-off asset types within ABS, but we are treading carefully.

DEBT-TO-INCOME FOR HOUSEHOLDS (LEFT) VS NET DEBT-TO-EBITDA FOR CORPORATES (RIGHT)



Source: Federal Reserve, BEA, J.P. Morgan. Courtesy J.P. Morgan Chase & Co., Copyright 2019.

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We maintain an overweight to non-agency RMBS versus agency MBS on the basis of incremental carry, naturally shorter durations, and high levels of credit support. RMBS spreads have been very stable despite the risk-off tone in other sectors. We like non-rate-sensitive, non-agency mortgage collateral pools. They offer better risk-return profiles versus traditional agency MBS pools. We are in the early stages of the residential credit cycle and continue to increase our non-agency RMBS positions as a result.

We continue to keep a core position in the CMBS sector. CMBS has exhibited low spread beta to corporates during recent heightened volatility environments. CMBS technicals are in great shape. While commercial real estate (CRE) valuations are at record highs, there has been minimal new construction. Refinancings are limited due to scant issuance from the 2008-2009 period. CRE debt as a percentage of GDP is well below its peak, unlike corporate debt that exceeds its peak.

The fundamental and technical picture within the securitized sector looks very good, and the shorter-duration assets that we focus on look attractive versus their risk-free counterparts from a break-even perspective. From a risk versus reward perspective, we believe we are not getting paid to invest lower down in the capital structure of new issue supply. We continue to err on the side of quality and are biding our time with respect to a pricing dislocation in the market.

TAX-EXEMPT MUNICIPAL BONDS

Municipal bonds performed well in the second quarter. While municipal yields continued to take their lead from U.S. Treasuries, strong demand, manageable supply, and a fairly benign credit environment proved most beneficial to municipals for the quarter and for much of 2019.

The supply/demand technical conditions for municipal bonds remained favorable during the quarter as demand continued to outpace issuance. Municipal bond funds have recorded 25 consecutive weeks of inflows with more than $43bn looking to get invested into tax-exempt municipal bonds. Investors are also seeing cash flowing back to them in the form of maturities and bonds being called or refunded, further swelling the strong demand for bonds. This technical is expected to get stronger in the coming months as the market continues to see net negative supply.

Following years of economic growth and fiscal austerity, municipalities have been able to strengthen their balance sheets, grow their rainy day funds, and in some cases pay down debt and improve their pension fund contributions. While high fixed costs such as pension funding and health care will continue to challenge municipal budgets, the sustained economic growth has proven to be a windfall for municipal balance sheets. Most states are meeting or exceeding revenue projections this fiscal year and are now in a stronger financial position to withstand the next economic downturn, should that occur.

While austerity measures have helped to strengthen balance sheets, infrastructure spending has suffered. As the prospects of a large federal infrastructure spending bill seem less likely given the current state of Washington gridlock, municipalities will likely have to fund these projects entirely on their own. Capital improvement projects are costly and can also strain balance sheets should the economy soften and revenue collections slow.

The latest news stories surrounding municipal credit are many, including climate change, ransomware attacks, and even recent lawsuits to invalidate some municipal debt. These events can challenge traditional municipal credit risks, particularly among more fiscally strained obligors. Issuers are just beginning to disclose some of these risks when issuing new debt into the market, particularly those of climate change. While difficult to forecast all natural disasters, it is important to know where the elevated risks exist and diversify investments away from those areas. Significant exposure to a single region or even industry can substantially increase the risk to a portfolio.

Overall, municipal bonds are experiencing a very good year of performance as demand is far outpacing supply. While the market may see supply increase due to funding of long-delayed infrastructure projects, we do expect it to remain manageable, especially if the demand for tax-advantaged investments continues to provide support for municipal bonds. While municipal yields are expected to continue to track U.S. Treasury yield moves, the strong technicals should be supportive of municipal bonds in the coming months, especially as the Fed's comments have lessened investor concern about possible upward movement in yields and lowering of bond prices.

For more detail on tax-exempt municipal bonds in the second quarter, please refer to Newfleet's 2Q19 Municipal Bond Market Review.

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Authored by:

The Newfleet Multi-Sector Team

Newfleet leverages the knowledge and skill of a team of investment professionals with expertise in every sector of the bond market, including evolving, specialized, and out-of-favor sectors. The team employs active sector rotation and disciplined risk management to portfolio construction.

Bloomberg Barclays U.S. Aggregate Bond Index measures the U.S. investment grade fixed rate bond market. Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index that measures the long-term tax-exempt bond market. J.P. Morgan GBI-EMGD tracks total returns for local currency debt instruments issued by emerging markets sovereign and quasi-sovereign entities to which international investors can gain exposure. J.P. Morgan CEMBI Index tracks U.S. dollar-denominated debt issued by emerging market corporations. J.P. Morgan EMBI Global Index tracks the total return for the U.S. dollar-denominated emerging markets debt, including Brady bonds, Eurobonds and loans. The indexes are calculated on a total return basis. The indexes are unmanaged, returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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