NOVEMBER 2019

House View

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Newfleet is a fixed income specialist and a multi-sector, relative value manager that actively rotates across 14 sectors of the investible bond universe. While we expect two-thirds of performance attribution over a full market cycle to come from sector allocation, our sector analysis and allocation decisions are made within the framework of a well-developed macro overview. In this piece, we discuss our current House View including key risks and impacts on portfolio strategy.

KEY ELEMENTS OF OUR HOUSE VIEW

- U.S. Treasury rates and credit risk spreads will remain in a range, following the YTD rally in both; lower rates and tighter spreads.
- Total return in U.S. fixed income markets will come from earning the yield, which is attractive in a world awash in USD15 trillion in negative-yielding debt wherein U.S. yields are the highest of the G-7, despite the country's safe haven status.
- The tone for credit markets will be set by the relative impact of additional global central bank easing and waning economic activity. We expect further central bank easing to counterbalance, but not fully offset, the decline in growth. The key is the pace of the anticipated growth slowdown.
- We expect global growth to slow enough to induce central banks to continue to ease, but not be so slow as to cause equity markets to come under sustained pressure, which would push credit risk spreads wider.
- This backdrop should sustain the current low inflation/low interest rate environment, combined with an orderly slowdown in economic growth.
- The fundamental question centers on whether the central bank of the world's largest economy (the Fed) can extend the longest economic expansion in history when unemployment is at a 66-year low, the equity market is close to an all-time high (despite corporate profitability at a five-year low, to which we would add overvalued), and the debt burden is also at a record high.
- In the setting we are depicting, the greater risk to credit-sensitive bond prices comes from spread widening, not higher U.S. Treasury rates.
- We believe the continued absence of inflation, buying support from global central banks, and high sensitivity of the U.S. economy to financing costs will prevent government bond yields from rising meaningfully.

KEY RISKS

Slightly below average credit risk spreads leave limited room for bond prices to "absorb" a slippage in growth. Yet growth continues to weaken. This, combined with our view that a rapid rise in the risk-free rate is unlikely, is why our concerns center on whether credit-sensitive markets remain patient enough (i.e., risk spreads do not widen) for growth fundamentals to catch up to "validate" spread levels. Changes in the following factors could disrupt the current delicate balance:

- G-3 + China central bank policies—do they do enough to keep markets stable?
- 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
- Brexit and the impact on continental Europe
- Bi-lateral political tensions between countries in the Mideast and the impact on the availability and price of oil
- Hong Kong protests and mainland China's response

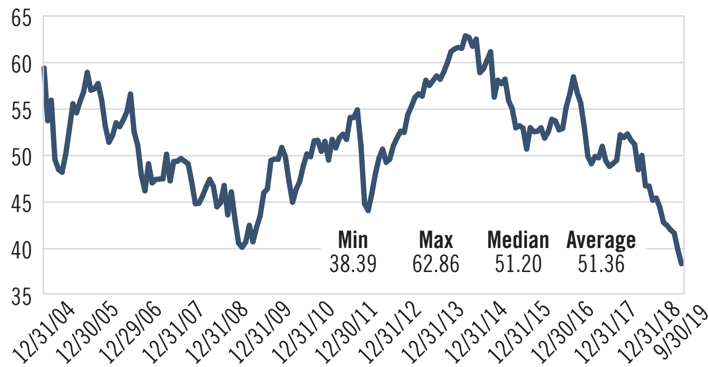
KEY IMPLICATIONS FOR OUR STRATEGY

Credit Quality and Currencies

Credit Quality

We remain engaged in below investment grade sectors of the bond market, but our overall exposure is below our historical averages.

HISTORICAL EXPOSURE TO BELOW INVESTMENT GRADE SECTORS (%)



Note: The above exhibit is of a representative account of our most flexible multi-sector strategy.

Credit Risk Spreads – While we expect the technical bid from central banks to offset waning growth, there is a risk that the perception of credit risk could rise as economic activity declines. This could apply widening pressure as spreads are average-to-slightly tight in most sectors.

What is to prevent them from widening?

- Buying power from renewed monetary easing: Fed and ECB policy rate cuts, no further Fed balance sheet contraction, and another round of quantitative easing in Europe.
- Private markets deploying their large stocks of negative-yielding debt into bonds with positive yields.

Why not tighter?

- The risk of markets not remaining patient enough for growth to catch up to "validate" spread levels; i.e., average spread valuations leave little room for further slippage in growth.

As a result, our overall credit risk exposure is below our historical average. Within this context, however, we do see some value in high yield emerging markets.

Market timing is very difficult and, over the long term, emerging markets has higher total returns than all other fixed income sectors. While U.S. high yield is close, 54% of the Emerging Markets Bond Index Global Diversified (EMBIGD) is investment grade.

Total Return	EMBIGD	USHY	JULI	UST	S&P 500
2004	11.6	11.1	6.0	3.7	10.9
2005	10.2	2.4	1.4	2.9	4.9
2006	9.9	11.6	3.7	3.1	15.8
2007	6.2	2.6	5.8	9.2	5.5
2008	-12.0	-26.6	0.8	14.3	-37.0
2009	29.8	58.2	18.2	-3.8	26.5
2010	12.2	14.7	9.4	6.1	15.1
2011	7.3	7.0	8.6	9.9	2.1
2012	17.4	15.4	9.6	2.2	16.0
2013	-5.3	8.2	-0.7	-3.4	32.4
2014	7.4	2.2	8.0	6.1	13.7
2015	1.2	-5.0	0.3	0.9	1.4
2016	10.2	18.9	6.1	1.1	12.0
2017	10.3	7.6	6.3	2.5	21.8
2018	-4.3	-2.4	-2.3	0.8	-4.4
Ytd 2019	13.0	10.9	12.9	8.1	20.6
Cumulative	213.8	211.7	145.0	84.0	270.2
Annualized	7.5	7.5	5.9	3.9	8.7

Source: J.P. Morgan Emerging Markets Bond Index (EMBI®) Monitor September 2019. EMBIGD: Emerging Markets Bond Index Global Diversified Index. USHY: J.P. Morgan Domestic High Yield Index. JULI: J.P. Morgan US Liquid Index (measures the performance of the investment grade USD denominated corporate bond market. UST: U.S. Treasury.

Recent financial market performance: Range-bound after the risk rally through July.

- The Fed pivot at the end of December 2018 and January 2019 drove a risk rally.
- The S&P 500® Index rose 21% through the end of July, despite little, if any, earnings growth. It has been flat since.
- The high yield corporate spread compressed by 152 basis points (bps), before widening by 27 bps.
- The high yield emerging market spread tightened by 140 bps, then widened by 44 bps.

CREDIT RISK SPREADS

			5 Year				10 Year			
Market Segment	**Current**	**Early 2019 High**	**Avg**	**High**	**Low**	**Range**	**Avg**	**High**	**Low**	**Range**
UST 10y YTM (%)	1.8	2.8	2.3	3.3	1.4	1.9	2.4	4.0	1.4	2.6
US High Grade	116	163	134	221	90	131	151	266	90	176
US High Yield	396	544	459	887	316	571	503	894	316	578
EM High Grade	176	253	217	337	157	180	211	337	138	199
EM High Yield	635	748	663	1081	455	626	601	1081	342	739

Source: Bloomberg L.P., as of October 25, 2019. US High Grade: ICE BofAML US Corporate Index, US High Yield: ICE BofAML US High Yield Index, EM High Grade: J.P. Morgan EMBI Global IG Sovereign, EM High Yield: J.P. Morgan EMBI Global HY Sovereign.

- U.S. investment grade tightened by 50 bps, then widened by 3 bps.
- The emerging market investment grade market sustained its rally through September 13, during which time the spread tightened by 75 bps, then widened by 11 bps.
- Within the corporate and emerging market sectors, high grade has outperformed because Treasuries have rallied both during the risk rally (central bank buying and negative yields in other countries) and the more recent bout of risk aversion (weaker growth and inverted government bond curves).

What happened in July?

- First, recall the two key macro drivers we have been discussing: 1) Fed policy, and 2) trade tensions between the U.S. and China, the world's two largest economies.
- Financial markets perceived both to have taken a turn for the worse toward the end of July:
  - The Fed delivered a "hawkish" cut, defined as a 25 bps cut in the federal funds rate, but accompanied by language that did not promise more to come.
  - In addition, U.S. President Trump, once again, expressed negative views on China's trade performance and policy.
- The combination of the two produced a risk-off backdrop, causing Treasuries to rally and stocks to sell off.

Currencies

Our local markets exposure remains less than 1%.

We like rates in several countries, but we dislike currencies more. We are retaining our strong dollar 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 (next bullet point), will continue to support the dollar. However, we are looking for select local market opportunities after the 12% rally in the dollar from February 2018 through the end of September 2019, again, selectively.

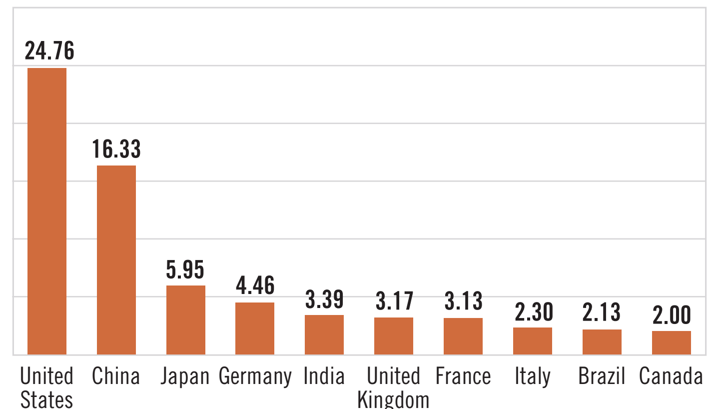
We maintain our view that the oil price (as measured by spot WTI) will remain in a $50-$70/barrel range. The supply/demand dynamics are balanced between subdued demand, due to slower economic growth, and rolling supply disruptions. However, at the end of the day, we give the edge to slower demand because supply disruptions usually get resolved quickly. The recent attacks on Saudi Arabia's Aramco facilities are an example, wherein the damaged facilities are expected to be back to full capacity by November. Also, on the demand side, China's marginal demand will continue to decline as the composition of its economy shifts toward more consumption/less manufacturing, and its fuel usage efficiency rises.

BROAD ECONOMIC OUTLOOK

Secular vs. Cyclical Trends, Evidence of the Downtrend, Recession Fears, the Debt Burden, Central Bank Policy Responses

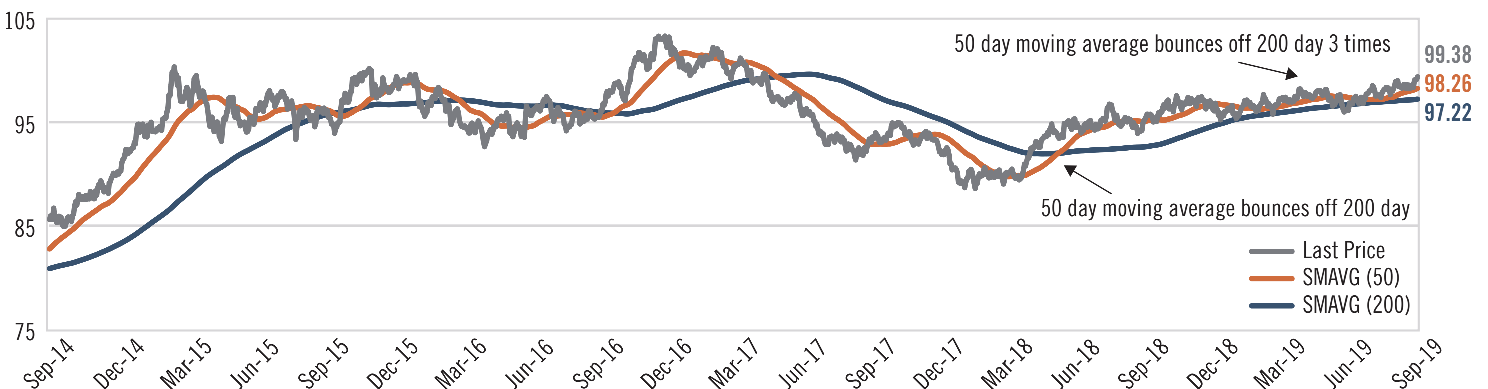
We expect a continuation of slowing growth and low inflation. While there are over 190 countries in the world economy, we gauge future prospects by looking at the U.S., China, Japan, and the major European countries.

PERCENT OF WORLD GDP



Source: IMF World Economic Outlook Database October 2019

USD INDEX



Source: Bloomberg. Note the acceleration in the USD rally after the 50-day moving average (orange line) crossed the 200-day moving average (blue line) in 2018. The uptrend was confirmed three times this year when the 50-day bounced off the 200-day.

Secular Trends

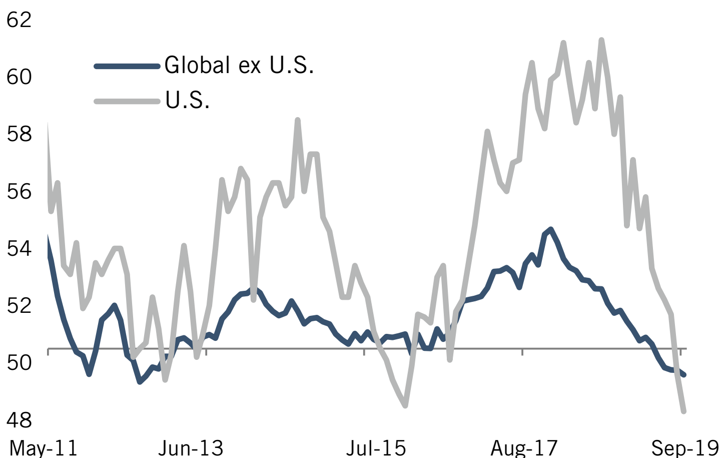
The U.S. will continue to be the best performer among major developed markets as much of the slowdown in the EU, Japan, and China are the result of secular trends:

- Japan's population is both declining and ageing, which has and will continue to lead to ever higher dependency ratios.
- Population growth in the EU is slowing and ageing, especially when excluding immigration, which is under heightened public scrutiny.
- The ratcheting down in China's growth to mid-single digits will persist because the country's composition of growth is evolving toward more consumption as incomes grow. This is exactly what we would expect, given China's current phase of development, much like what happened in post-World War II Japan and then Korea.

Cyclical Trends

Global PMIs have been rolling over and now the U.S. is following:

GLOBAL MANUFACTURING PMI



Sources: Morgan Stanley Research

KEY METRICS OF MAJOR ECONOMIES

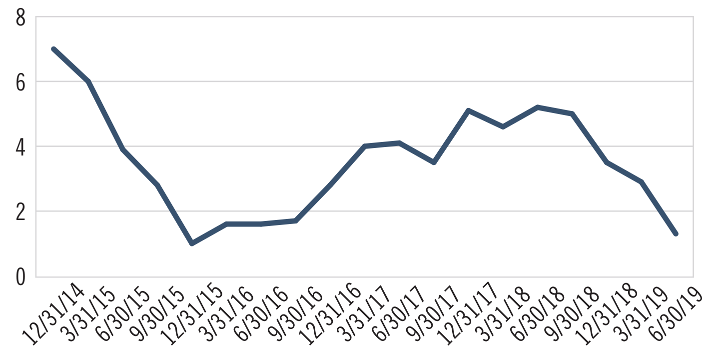
	U.S.		EU		Japan		China	
	2019	2020	2019	2020	2019	2020	2019	2020
Real GDP Growth	2.1	1.8	1.3	1.1	0.9	0.2	6.0	5.7
CPI Inflation	1.7	2.0	1.3	1.3	0.5	0.5	2.5	2.1
Policy Rate	1.5-1.75	1.25-1.5	0.0	0.0	-0.1	-0.1	4.1	4.1
10y YTM	1.5-2.0	1.5-2.0	-0.5	-0.3	-0.2	-0.3	3.0	2.8

Source: Newfleet estimates, as of October 25, 2019

Evidence of the Downtrend

Hard data, e.g., industrial production, corroborates the downtrend.

U.S. GDP GROSS PRIVATE DOMESTIC FIXED INVESTMENT
(percent change year over year)



Source: Bloomberg L.P.

The drivers of the downtrend include the negative growth impulse from the trade war between the U.S. and China, the potential for a hard Brexit, and the elevated global debt burden in the latter stage of the cycle. The situation is exacerbated by the continued absence of a fiscal response, especially in Germany.

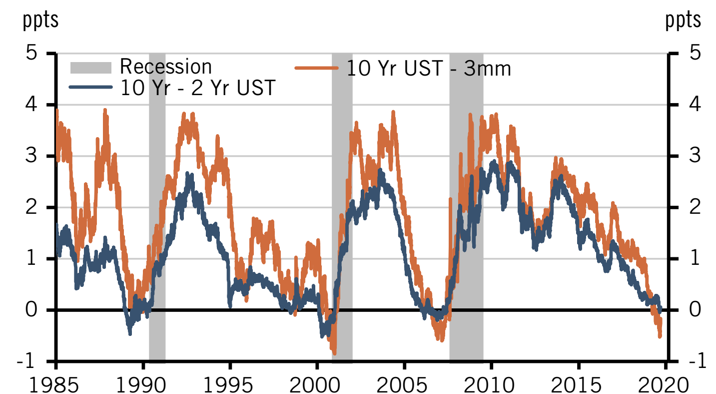
We are closely watching whether lower business activity starts to impact the consumer. In the U.S., the weaker manufacturing PMI is already spilling over into services PMI (closer to the consumer). We are tracking labor market conditions to see if this starts to translate into hard data. Elevated asset markets (wealth effect) lead us to the labor market as the most likely transmission channel. Here, we have yet to see signs of weakness, as reflected by the lowest unemployment rate since 1953.

So far, central banks have been able to support growth alone, but the bond market is skeptical that this can continue without concomitant fiscal easing. So are we.

Recession Fears

U.S. Treasury yield curve inversions have been a very reliable indicator of recession because the shape of the term structure reflects the views of many (weaker growth going forward, and

U.S. YIELD CURVE



Source: Refinitive Datastream, as published in HSBC Research

thus less risk of longer rates rising, induces buying of long bonds to lock in rates), while the short end is more heavily influenced by Fed policy (recall the Fed just hiked in December 2018).

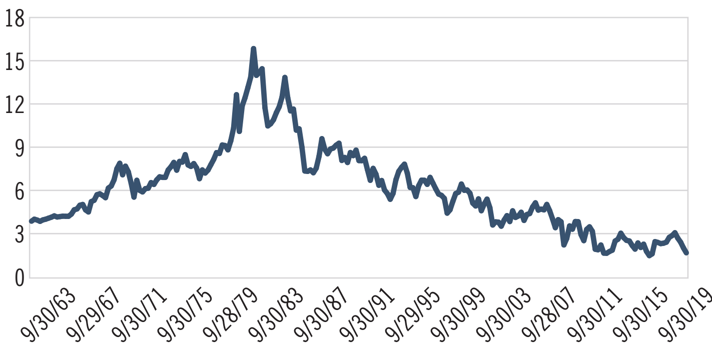
The potency of central bank policies to stoke growth without help from more fiscal stimulus is declining. Germany still has a fiscal surplus and Japan is hiking value-added taxes. We think this is why developed country yield curves are pricing in the potential for a recession, as reflected by:

- $15T of global debt with negative yields
- Inverted Japanese and German government bond curves
- The shape of the U.S. Treasury curve is inverted at the short end and flat through the intermediate tenors. This has been a reliable indicator, as it represents the aggregate views of many as opposed to the government-manipulated federal funds policy rate, which was hiked 10 months ago.

Debt—An Unsustainable Global Burden

For a given level of economic growth, if debt keeps getting bigger, rates have to fall so debt service does not drag consumption lower. However, rates in the U.S. are already low and debt as a percentage of GDP will continue to rise because of higher spending on social security and Medicare/Medicaid at a time of no growth in tax revenue. The situation in Japan is more problematic as Japan has even more debt, less growth, and a population that is both shrinking and ageing faster. U.S. debt to GDP of 250% is slightly below the developed country average of 266%, while Japan's ratio of 375% is the highest. The growing burden has been sustainable because the cost came down after stagflation was vanquished in the mid-1980s. However, the cost cannot go much lower from here. This raises the economy's degree of sensitivity to changes in interest rates, which would act as an automatic growth suppressant if they were to rise.

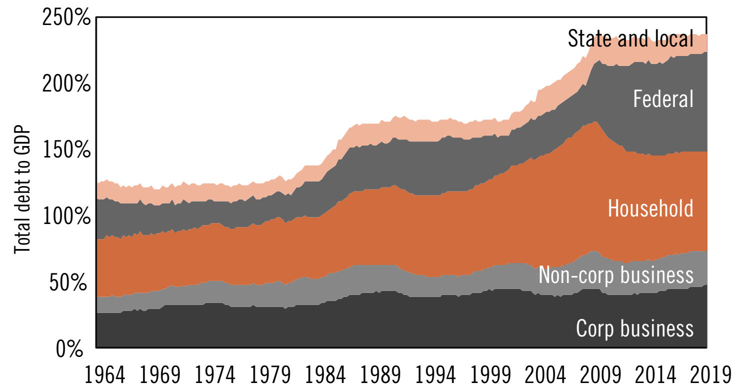
10-YEAR U.S. TREASURY YIELD TO MATURITY (%) – 3/30/62-9/30/19



Source: Bloomberg LP.

Growth in total debt in the U.S. accelerated rapidly since the early 1980s when interest rate deregulation began in earnest. Another increase, which occurred on a global scale, occurred in response to the 2008 global financial crisis.

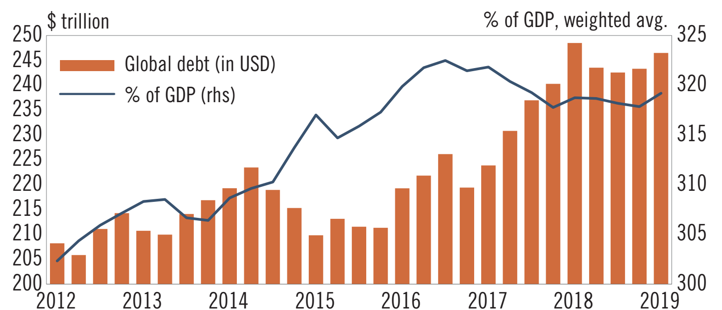
U.S. TOTAL DEBT TO GDP 1964 TO 2019



Source: HSBC Research, Federal Reserves

After a decade of quantitative easing, total global debt has increased dramatically.

TOTAL GLOBAL DEBT



Source: Institute of International Finance

In the U.S., there has not been a cathartic debt purge to reset the beginning of a new cycle such as in the late 1970s-early 1980s period of stagflation. The current cycle has seen consumer debt decline since the financial crisis, but total debt has risen. This is because consumer debt was merely transferred to the government's balance sheet when the government intervened to clean up the financial system in 2008. The debt remained serviceable because interest rates declined. Today, a high debt load plus low rates leaves the economy sensitive to interest rate changes. This, plus slowing growth, should suppress the level of interest rates.

Policy Response—Will Governments Do Their Part?

On the growth front, we are monitoring whether governments start to ease fiscal policies to stimulate demand. So far, central banks are shouldering most of the burden:

- The Fed has the most room to ease. It is cutting the policy rate target, and renewed quantitative easing (however classified) could be in the offing.
- The ECB has just cut the deposit rate and said its revived quantitative easing program would "do whatever it takes."

- China's central bank continues to use multiple tools to ease monetary policy. The recent focus has been to stoke bank lending, including lower reserve (cash set aside to backstop deposits) and lending rate requirements.
- In addition to China, several other large emerging market central banks have followed suit. These include Brazil (where inflation is at an all-time low), Russia, India, and, more recently, Mexico. Mexico had been waiting for trade tensions and resultant currency pressure to fade before engaging in an easing program, which commenced on September 26.

While global monetary policy easing has been laudable, it is unlikely that global central banks, especially the Fed and ECB, can pump up the slowing global economy enough to offset the hit from trade tensions between the two largest economies in the world, the U.S. and China.

THE MAJOR ECONOMIES

The U.S., Europe, Japan, and China

U.S.—Positive, But Slowing Growth

- Why not lower interest rates? Rates are already slightly negative in real terms, and the U.S. economy continues to perform well. While the Phillips curve is dormant, at some point, resource inputs will matter. The labor market is very tight, with unemployment of 3.5% the lowest since 1953.
- Why not higher? On the domestic front, there is the continued absence of inflation and the inapplicability of the Phillips curve (at least for now). The current paradigm, wherein low inflation and unemployment co-exist, emanates from increased production efficiency, defined as getting more production from fewer labor inputs due to technological advancements (i.e., more output from less labor input), and price discipline from greater global trade and competition from higher levels of imports from countries with lower labor costs, primarily China.
- While growth remains positive, it is slowing. Domestically, business fixed investment spending has led growth. Externally, the global growth slowdown is having more of an impact, exacerbated by trade and geopolitical tensions.

Europe—Further Monetary Easing Amid Weaker Growth

- Unconventional policies will remain in play given low inflation and looming recession, Germany included.
- Negative interest rate policy is mostly symbolic—all rates are essentially 0% and the ECB is motivating banks not to leave money with it by charging banks for deposits instead of paying interest. On September 12, the "depo" rate (rate the ECB pays banks for deposits) was cut to -0.50% from -0.40%.
- Quantitative easing was resurrected in the amount of €20 billion/month and is transmitting fully to market-determined rates. A critical element of the decision is the open-ended duration of the program—"as long as it takes"—to spur growth and tackle chronically low inflation.
- Population trends, which are better than Japan but worse than the U.S., present challenges to future growth. EU growth is still positive at 0.5%, but it is negative excluding immigration, which is slowing. In terms of a dependency ratio, the worker per retiree ratios of Germany and France are both about 3.0, mid-way between the U.S. (4.1) and Japan (2.2).
- Germany (the largest EU economy at 18%) has already slipped into recession. It is worth noting that Germany is the most open economy of the G-7 (in terms of proportion of aggregate economic activity consisting of trade). A key driver of backward-looking historical activity has been the slowdown in the automotive industry in the U.S. and China. The negative impact on manufacturing confidence from Trump's tweets about auto tariffs completes the picture on forward indicators. German manufacturing PMI of 41.9 is down about one-third from 63.3 at year-end 2017 and is at the lowest level since the depths of the global financial crisis in 2009.
- Activity in the UK (the second largest EU economy at 12%) is slowing further as the Brexit saga continues.
- The results? Bund yields are now more negative than Japan, and the yield curve is flat out to 10 years. On the positive side, there is an abundance of surplus cash to invest in other countries, like the U.S. and emerging markets.

Japan—Continued Stagnation

- Japan has one of the developed world's least favorable demographic situations for economic growth, in no small measure the result of a historical aversion to immigration.
  - Population growth has declined every year since 2010 (the worst of the most populous countries) versus growth of 0.6% for the U.S. over the same time period.
  - The worker/retiree ratio is 2.2, half that of the U.S. ratio (4.1).
- Japan's equity market cracked 30 years ago and still sits at nearly half of its year-end 1989 peak. With low inflation and growth defining the landscape, unconventional policies remain in place: 20 years of negative policy rates, yield curve control to bring "market determined" rates in line, quantitative easing, strong forward guidance, and ETF purchases.
- Japan has the largest debt burden in the world, partially offset by the ability to roll it domestically, but no growth to relieve it.

- The result? Japanese government bond yields will remain negative, and the yield curve flat. On the positive side, there is plenty of surplus cash to invest in other countries. Japan is the second largest holder of U.S. Treasuries ($1.0T) next to China ($1.1T), and both well in excess of the third largest (Brazil at $300M).

China—Economic Data Trending Weaker

- Recent data points are generally below expectation and confirm a long-term gradual decline.
  - Industrial production was 5.8% year-over-year, 40 bps below the five-year average of 6.2%.
  - Retail sales were 7.8% year-over-year, down from 11.9% five years ago.
  - Official Manufacturing PMI at 49.8 remained below the critical expansionary/contractionary threshold level of 50.0.
  - The above results do not take into account the additional tariff hikes administered in September.
- Status of Trade Talks: relations between the U.S. and China have thawed recently, but the probability of a major resolution remains low in our view. We could see some modest agreement in certain areas (a “mini deal”), which would support investor sentiment.

China’s weakness is led by industrial production, where growth is the lowest since the early 1990s. While much of this is attributable to China’s maturation to a less intense growth phase as its economy matures, the slowdown since the global financial crisis is notable.

CHINA VALUE-ADDED INDEX (Chinese Equivalent of Industrial Production)
1/1/89 – 9/30/19

Bloomberg L.P.

While China’s economic growth is slowing, it is not collapsing. GDP growth, while high at 6.1% for this year, is in a downward trend. The economy grew at a rate of 8-14% during the 1990s through the onset of the global credit crisis in 2007, about the time when commodity prices peaked. China’s economy is in a phase of a structural deceleration in growth as population growth slows and as the savings rate declines as consumption increases. This trend will intensify as the average income rate rises. The reason is that China is slowly making a structural transition in its economic model to more consumption from industrial production. The same thing happened in Korea, where high growth in the 1960s through 1980s started to slow in the 1990s as the economy matured. While China’s economy is not yet reaching the mature phase, it is no longer in the high growth phase either.

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Past performance is not indicative of future results.

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. **Foreign & Emerging Markets:** Investing internationally, especially in emerging markets, involves additional risks such as currency, political, accounting, economic, and market risk.

The **J.P. Morgan Emerging Markets Bond Index Global (EMBI Global)** is a market capitalization weighted index that tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. The **J.P. Morgan Emerging Markets Bond Index Global Diversified (EMBI Global Diversified)** is a uniquely-weighted version of the J.P. Morgan EMBI Global Index. The index limits the weights of those countries with larger debt stock by only including specified portions of these countries' eligible current face amounts of debt outstanding. The countries covered in the EMBI Global Diversified Index are identical to those covered by the EMBI Global Index. The **J.P. Morgan EMBI IG Sovereign and EMBI HY Sovereign** are sub indices of the EMBI Global and Global Diversified indices. An instrument is classified in its respective credit bucket using Moody's, S&P, and Fitch ratings. The **J.P. Morgan Domestic High Yield Index** is designed to mirror the investable universe of the U.S. dollar domestic high-yield corporate debt market, including issues of U.S. and Canadian-domiciled issuers. The **J.P. Morgan U.S. Liquid Index (JULI)** measures the performance of the investment grade U.S. dollar-denominated corporate bond market. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **ICE BofAML U.S. High Yield Index** tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market and includes issues with a credit rating of BBB or below. The **ICE BofAML U.S. Corporate Index** tracks the performance of U.S. dollar-denominated investment grade corporate debt publicly issued in the US domestic market. Indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment.

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