Q1 21 MULTI-SECTOR FIXED INCOME

MARKET REVIEW AND OUTLOOK

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

The first quarter brought bursts of optimism as the world continued its uneven recovery from the COVID-19 pandemic and the economic lockdowns that dominated 2020. Tremendous progress in the development of a vaccine and a thus far effective delivery system of administering doses to a meaningful proportion of the population have put the U.S. on a path to normalcy. During the quarter, some of the uncertainties in domestic politics were resolved as the new administration accomplished the much anticipated next round of fiscal stimulus to keep the economic recovery on track. The $1.9T American Rescue Plan Act was signed into law on March 11 and delivered another round of direct payments to individuals, enhanced unemployment benefits, and aid to states. Further stimulus measures may take shape in the months ahead as political dialogue turns toward infrastructure.

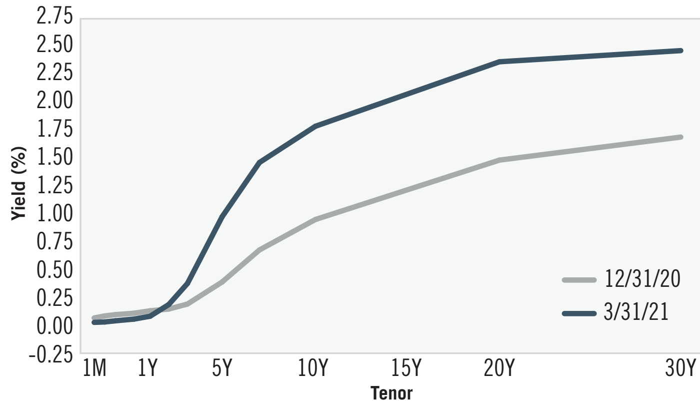
Markets have shifted their focus to the implications for the future, which included some rotation in U.S. equity markets and a renewed debate on the global outlook for inflation. We believe that base effects related to last year's disruptions will lead to elevated inflation readings in the near term, but we expect those data points will be transitory and likely to fade into the second half of the year. Secular developments in technology and the effects of globalization continue to help keep prices contained, and cyclical components such as unemployment and broad resource slack will help cap inflationary pressures as well. This view is reinforced by a U.S. Federal Reserve that remains dovish and committed to keeping policy accommodation in place until it achieves its mandates on both inflation and employment. We believe that policymakers globally will remain supportive of continued economic recovery.

In our view, economic activity and corporate earnings will continue to rebound over the course of the year. Financial markets were mixed during the quarter. We believe sector and issuer selection in this environment is critical and favors active over passive management. Elevated cash levels and a high degree of personal savings will be a tailwind to growth.

The Federal Open Market Committee (FOMC) left its federal funds target rate unchanged at a range of 0-0.25%, the rate that was set in late March 2020 in response to the pandemic. The Federal Reserve completed a policy review in the third quarter of 2020 that resulted in the adoption of average inflation targeting. The policymakers are looking for inflation to average 2% over time. Recent inflation shortfalls versus this target suggest that the FOMC will be willing to allow periods of inflation in excess of 2% to achieve their objective. This supports our view that policy rates are likely to stay lower-for-longer as long as economic conditions warrant.

During the quarter, U.S. Treasury rates increased across the majority of the curve with the largest increases 10 years and longer. The 5-year Treasury yield rose 58 basis points (bps), the 10-year Treasury yield rose 83 bps, and the 30-year Treasury yield was 77 bps higher. Shorter maturities were lower to a lesser extent.

U.S. TREASURY YIELD CURVE

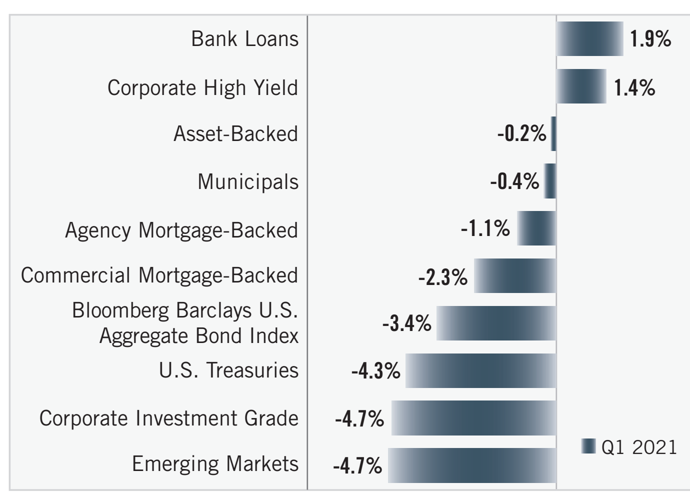


Source: Bloomberg L.P.

FIXED INCOME SECTOR PERFORMANCE

Most spread sectors outperformed U.S. Treasuries during the quarter led by those with less interest rate sensitivity such as corporate high yield, bank loans, and securitized product. While there was no clear performance trend between rating tiers, there were notable exceptions within high yield, bank loans, and most securitized sectors, where lower quality generally outperformed. Shorter duration also outperformed.

FIXED INCOME SECTOR PERFORMANCE



Performance as of March 31, 2021.

Sources: J.P. Morgan: Emerging Markets (EMBI Global), Corporate 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.

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

CORPORATE INVESTMENT GRADE

Corporate investment grade (IG) experienced an ugly start to the year with a total return of -4.65% in the first quarter. Creeping duration that peaked just shy of nine years finally came back to hurt investors. The total return for the 10+ year IG index was -8.51% versus a modest -0.59% for the 1-5 year index. Excess returns were positive during the quarter (+0.95%) as spreads tightened five basis points to 91. This was hardly any consolation to investors. The reality was that, with spreads 25 bps through their longer-term averages and close to historical lows on a duration-adjusted basis, there was insufficient cushion to absorb a rate move like the one that occurred. That remains true as the second quarter begins.

Gross and net supply fell 3% and 12%, respectively, from last year's record pace and will undoubtedly fall further behind as we lap two of the largest issuance months of all time in April and May. That said, we were a little surprised at the persistency of high supply to begin the year. Yields remain low by historical standards, but were rising so quickly that many treasurers opted to lock in a low cost of financing while they could. Yields ended the quarter 27 bps higher to 2.28%. The move was sharp, but yields remain nearly 1% below the five-year average. Looking ahead, supply will likely moderate as issuers are sitting on large cash balances and elevated leverage.

The fundamental outlook is supportive. While EBITDA did decline in 2020, earnings were far better than consensus forecasts throughout the year. Earnings beat analyst expectations by 23% in the second quarter, 19% in the third, and 17% in the fourth. For 2021, the consensus forecast sees 25% earnings growth for the S&P 500. Issuers were generally on their best behavior. Per JP Morgan, the payout ratio was 36% in the fourth quarter of 2020, its lowest mark in seven years. Nearly 80% of companies curtailed share buybacks in 2020 with more than 20% cutting dividends.

After recording $200 billion of fallen angels in 2020, there has been just $2.8 billion in debt downgraded to high yield in 2021. We expect fallen angel activity to be muted and well below levels of rising stars – this is typical of years following a recession.

Valuations are the main impediment to better returns as our outlook for both technicals and fundamentals is favorable. However, we still see pockets of opportunity in an extremely large asset class. This includes select BBBs, bank hybrids, and bonds in COVID-19-sensitive industries.

CORPORATE HIGH YIELD

The corporate high yield market finished the first quarter of 2021 in positive territory following a robust finish to 2020. The quarter was led, once again, by CCC rated credits as the investor community continued its search for yield while attempting to limit interest rate risk. Increasing vaccine rollouts that have allowed local economies to reopen, a continuation of loose monetary policy by the Fed, and another stimulus package all supported the rally in risk assets. These aggressive policies to drive economic growth have raised inflation concerns. During the first three months of 2021, U.S. Treasury rates rose and the yield curve steepened – longer-dated maturities saw larger increases in yield relative to shorter-dated maturities. This move hampered performance for interest rate-sensitive high yield bonds, namely BBs, which posted a slightly negative return for the quarter.

The continued demand for risk assets, record-low yields, and inflation concerns all prompted corporate treasurers to issue debt at a record pace in the first three months of 2021. The first quarter saw $158.6 billion of issuance, the most active quarter on record. Meanwhile, flows were negative into the asset class. Positive returns for the asset class may seem at odds with record issuance in the face of outflows. However, 77% of issuance was used to refinance existing debt and this follows 2020 where that same metric was 66% – the end result is that supply and demand remain in balance. While down from last quarter's pace, CCCs comprised 9.1% of issuance in the first three months of 2021, a pace that remains well above average for lower-rated credits. With fundamentals continuing to improve as the economy reopens, the default rate has decreased to 5.50% through March 31, which is down over 1% from its post-crisis high and should fall rapidly throughout the year.

Valuations screen rich relative to history with the spread on the index at a 14-year low, reaching levels not seen since before the 2008 financial crisis. Investors remain concerned with interest rate risk over credit risk, which has led to CCCs outperforming higher-rated buckets. In the middle of February, the yield on the index hit an all-time record low of 3.9% before rising into quarter end. Despite these elevated valuations, our outlook for the rest of 2021 remains positive for high yield as we should see a rebound in fundamentals as the economy reopens. This fundamental improvement should be the dominant factor over elevated valuations and a mixed technical environment. Lastly, we continue to remain focused on balancing the lack of convexity (refinancing risk) with duration (sensitivity to interest rates) across portfolio holdings.

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BANK LOANS

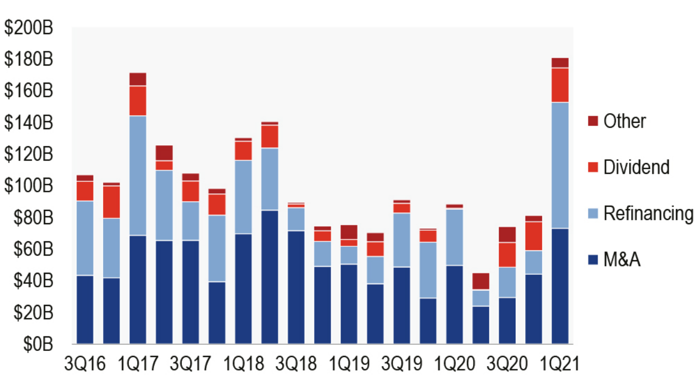
The bank loan market posted solid performance in the first quarter. Heightened attention to interest rate risk, and the actual impact of rising rates on fixed-rate investments, was a primary driver of the loan market's outperformance versus almost every fixed-rate asset class. While the loan market had positive returns in each month, March was weak as heavy new issuance – bringing supply into better balance with demand – resulted in softer prices. The backdrop for bank loans remains overall positive with favorable macroeconomic conditions, supportive monetary and fiscal policies, and strong, liquid capital markets.

Lower quality continued to outperform higher quality over the quarter as investors searched for yield. CCCs (+7.49%) outperformed Bs (+1.54%) and BBs (+0.71%), as measured by the Credit Suisse Leveraged Loan Index. All industries posted positive returns for the quarter with the exception of media/telecom – broadcasting (-1.31%). Industries affected by COVID-19 generally outperformed on optimism regarding reopening of the economy while more defensive areas lagged. Benefiting from higher oil prices, energy (+7.37%) led the outperformers, followed by transportation – shipping (+6.20%), gaming/leisure (+3.59%), consumer non-durables (+3.41%), and metals/minerals (+3.25%). Laggards included utility (+0.25%), media/telecom – cable/wireless (+0.55%), financial (+1.16%), and food & drug (+1.30%).

Technical conditions (supply/demand) remain highly supportive. Per JP Morgan, retail fund inflows totaled $11.1 billion for the quarter, recording now four consecutive months of inflows (recall that total outflows in 2020 were $27 billion). Collateralized loan obligation (CLO) issuance continued to be robust with $38 billion (ex-refinancing) for the quarter, compared to $17.9 billion for the comparable period in 2020. CLO demand is underpinned by a combination of falling liability costs, resurgent bank loan issuance, attractive relative value, and pent-up supply from CLO managers. One of the big stories for the quarter was the high amount of loan issuance in March ($89B, bringing the year-to-date total to $301B) as supply started to catch up with strong demand. A meaningful proportion of new issuance was refinancings – 51.5% for the month and 31.6% for the quarter. Though demand outstripped supply in March, the surge in issuance served to bring the loan market into better balance. Going forward, we expect that demand will remain strong and that supply will be manageable. The amount of repricings is a concern. If another wave of repricings occurs, there could be an adverse impact on all-in coupons.

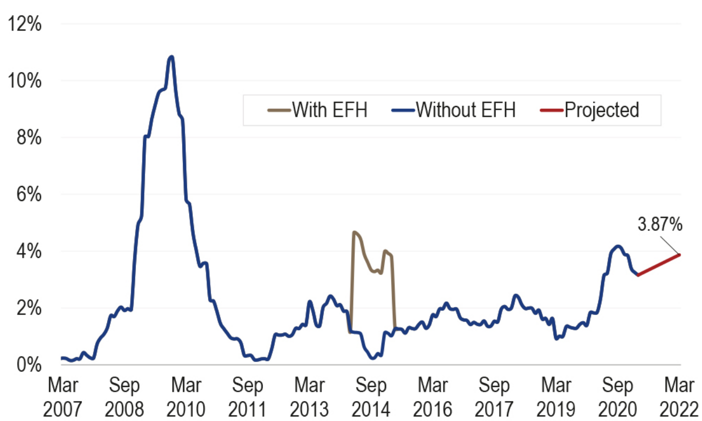
Fundamentals have stabilized and are set to get better driven by the reopenings and the wall of Fed-induced liquidity that has led to broad capital market access. Earnings have consistently improved since the trough of the second quarter of 2020 and are likely to improve further given their high correlation to GDP and nominal GDP forecasts in the range of 7.5% for 2021. The downgrade/upgrade ratio is leveling out. The default rate has declined for six straight months and now sits at 3.15%. The current default cycle may have already peaked at 4.17% in September 2020 and may decline further in the near term as 2020 defaults roll off the last-12-month calculation.

U.S. INSTITUTIONAL LOAN VOLUME, BY USE OF PROCEEDS



Data through March 31, 2021.
Source: LCD, an offering of S&P Global Market Intelligence.

U.S. LEV'D LOAN DEFAULT RATE (FORECAST THROUGH MARCH 2022)



Data through March 17, 2021. EFH = Energy Futures Holdings
Source: LCD, an offering of S&P Global Market Intelligence.

There are two areas of concern that may affect loan market fundamentals. First, the period of balance sheet repair has been truncated in this recovery such that weakened documentation and EBITDA adjustments and aggressive deals have reappeared. The longer-term risk is deteriorating quality of issuance and the potential impact on default and recovery levels. Second, an inflationary environment poses problems for companies given its potential impact on gross margins, and in turn cash flow, and borrower debt service metrics.

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The loan market closed the quarter at an average price of 97.6, having started the year at 96.2. The majority of the market (52%) is priced between 99 and par, and roughly 10.6% of the market is priced over par. Distressed loans (priced below 80) account for roughly 1.1% of the market. Loan spread to a 3-year life ended March at L+434 in March. While this level is inside historical long-term averages, we believe loans still have room to tighten on the back of an improving economy, increased demand to hedge duration risk, market discount, LIBOR floors, and investor need for yield.

Update on LIBOR: The quarter saw a milestone reached in the LIBOR cessation process. On March 5, the Financial Conduct Authority (FCA) and the ICE Benchmark Administration (IBA) announced that 35 LIBOR settings will either cease to be provided or no longer be representative. This will occur on December 31, 2021 for USD 1-week and 2-month LIBOR. Remaining settings will cease on June 30, 2023. Additionally, while most tenors of USD LIBOR will continue past December 31, 2021 for legacy contracts, the US Banking Regulators have stated that they may not be used for origination after December 31, 2021. At this point in time, the Secured Overnight Financing Rate (SOFR) appears to be the likely replacement rate.

Our outlook for the bank loan market is constructive based on a favorable earnings outlook, wide open capital markets, slowing defaults, and firm technical conditions. Given diminished total return potential, the market is turning into more of a coupon-clipping environment. For investors looking for income, duration management, and an attractive risk-adjusted return profile, the loan market offers a credible solution.

In terms of overall strategy, we have returned to an emphasis on credit selection and loss avoidance as the primary drivers of future outperformance. A year ago, we were looking for market dislocations and underwriting the total return opportunities to take advantage of COVID-19. Today, we are focusing primary issue investments on various themes we see in a transition to a vaccinated world, including: 1) identifying business models that may be permanently altered by the pandemic, 2) winners and losers in a post-vaccine world, 3) altered consumer spending habits, and 4) the impact of inflation on margins and debt service.

EMERGING MARKET DEBT

Emerging market (EM) sovereign debt posted a dreadful -4.74% total return (JPM EMBI Global Index or EMBIG) in the first quarter of 2021 despite sovereign index spread levels being absolutely unchanged – beginning and ending the period at 320 bps.

The negative return resulted from the material upward shift in U.S. Treasury rates combined with the long duration of the index at almost eight years. U.S. Treasury yields rose sharply during the period with the 10-year yield moving higher by 83 bps to end the period at 1.74% – the highest level since January 2020 – and the 30-year yield moving up by 76 bps to 2.41%.

While the index spread was unchanged, the index yield rose to 4.93% from an all-time low of 4.26% at year end, a bit more attractive but still relatively low from a historical context. Index spreads remain on the tighter end of historical valuations as well, inside the five- and 10-year average index spreads of 362 bps and 360 bps, respectively.

Some performance highlights in the quarter:

> The investment grade segment (-4.98%) underperformed the high yield segment (-4.37%). The BBB credit quality tier was the worst performing category with a -5.70% return for the quarter.

> Within the BBB rating bucket, Peru, Panama, Colombia, and Uruguay were among the worst performers with negative total returns ranging from -7.41% to over -9.43%.

> The two worst performing country indices were Argentina (-15.14%) and Ecuador (-13.13%) reflecting continued economic woes in the former and a negative election outcome in the latter. The best performing countries also came from the distressed universe and included Venezuela (+16.52%), Sri Lanka (+10.13%), and Zambia (+8.91%).

> Although still negative, EM corporate bonds, which have shorter duration, outperformed the sovereign index; the main corporate index (CEMBI Diversified) returned -1.0%.

Local market bonds also had a rough quarter. The main index, the JPM GBI-EM Global Diversified, recorded a -6.68% return in the period including foreign exchange losses of -3.6%. Turkey (-20.0%), Brazil (-12.89%), and Colombia (-12.42%) were major losers during the period while China eked out a slightly positive return.

Finally, gross EM debt issuance was high during the first quarter and is expected to remain so throughout the year as governments access the capital market to help fund budget gaps. Meanwhile, flows into EM bonds have been healthy year to date and we expect this trend to continue given relatively attractive yields.

From a strategic standpoint, we continue to favor U.S. credit sectors over EM as the U.S. is at the forefront of the global vaccination effort and will lead the global economic recovery. The recent surge in COVID-19 cases and the slow rollout of vaccines across most EM countries lead us to conclude that the recovery for most EM economies is going

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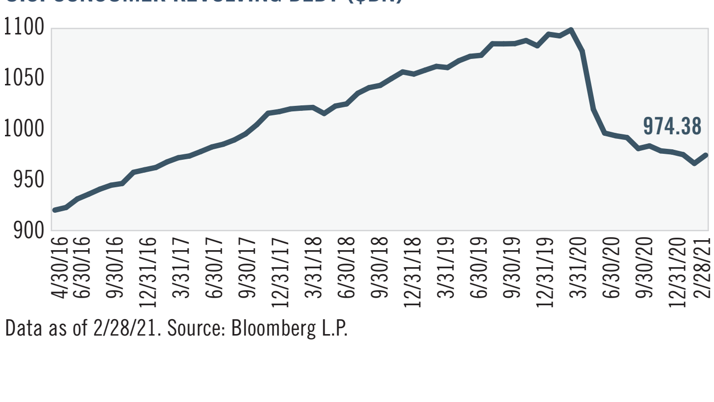
to take longer than developed market (DM) counterparts with many countries not returning to pre-pandemic GDP levels until 2023. Within EM, those countries with economies reliant on tourism and service sectors are likely to take even longer. We continue to favor less rate-sensitive high yield issuers.

SECURITIZED PRODUCT

First quarter 2021 performance was a mixed bag for the securitized markets. Longer duration sectors, namely commercial mortgage-backed securities (CMBS) and agency mortgage-backed securities (MBS) produced negative returns while shorter duration sectors like asset-backed (ABS) and non-agency residential mortgage-backed (RMBS) securities were flat for the quarter. After a volatile 2020, the first quarter of 2021 was benign. All securitized sectors experienced minimal spread movement. CMBS and ABS spreads were slightly tighter but not meaningfully. Agency and non-agency MBS were also flat. Market technicals remain firm as ABS issuance is near last year's pace while agency MBS supply is elevated but less than 2020. CMBS issuance is down 34% from last year's first quarter pace; non-agency RMBS supply off by 40% year to date.

Considering consumer fundamentals, the unemployment rate continued to trend lower during the quarter going from 6.7% this past December to 6.0% at the end of March. The economy added 916,000 jobs during the month of March, which is the strongest jobs number over the last eight months. A third stimulus package hit consumers' wallets during the quarter. At $1,400 per person and a household income cutoff of $150,000, roughly 85% of U.S. households received the stimulus payments. In addition, tax refunds are also adding more cash to wallets. Empirically, we have witnessed that two-thirds of the stimulus dollars has been used toward savings, investing, and paying down debt. One just needs to take a look at the outstanding amount of consumer revolving debt. At the beginning of the crisis, revolving debt totaled almost $1.1 trillion and today it stands at $974 billion.

U.S. CONSUMER REVOLVING DEBT ($BN)

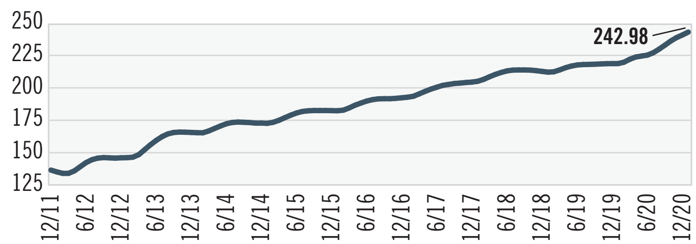


Data as of 2/28/21. Source: Bloomberg L.P.

In contrast, the commercial mortgage market is a bifurcated market with respect to fundamental performance. Property types such as data center and industrial are performing extremely well while hotel and certain retail property types (e.g., low- to mid-tier malls) continue to suffer due to the pandemic. Currently, the office segment continues to perform well due to long-term leases that are in place. However, the verdict is still out as to how office properties will perform in the near future as underlying tenant leases mature, especially in high-cost markets. Over the past quarter, the delinquency profile within CMBS improved slightly. However, the CMBS market is still credit shy. The CMBS credit curve between senior-rated bonds and junior-rated bonds remains much wider than pre-COVID-19 due to the lingering uncertainty regarding the health of the commercial real estate market.

The housing market continues to climb and, in turn, so does the performance of the non-agency RMBS market. We see strong demand for all residential mortgage products. The chart below demonstrates the strength of the housing market even during the pandemic. The latest Case-Shiller report shows an 11.1% year-over-year gain in January 2021.

S&P CORELOGIC CASE-SHILLER 20 CITY INDEX



Data as of 1/31/21. Source: Bloomberg L.P.

Regarding first quarter total return performance, the securitized components of the Bloomberg Barclays U.S. Aggregate Bond Index returned -0.16% for ABS, -2.32% for CMBS securities, and -1.10% for agency MBS.

It is fair to say that we are currently in a coupon-clipping environment within the securitized space. Spread levels for the majority of asset types are at or near the historical lows experienced over the last decade. Assets whose spread levels remain at wider levels are all sectors that are experiencing stress (e.g., airline lease paper, malls, and hotels). During the first quarter, we focused our efforts on the new issue markets. For example, we had a wave of supply in the ABS sector during the first two months of the year but spread levels not only hung in there but tightened. Fund flows have dominated the short part of the yield curve and, as a result, a lot of dollars were chasing too few assets during the first quarter.

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We have focused new dollar investments on the more conservative parts of a capital structure within a transaction and we look to pick our spots in terms of taking on credit risk.

TAX-EXEMPT MUNICIPAL BONDS

The municipal market outperformed most other segments of the bond market during the quarter as the anticipation and ultimate passage of the $1.9 trillion American Rescue Plan Act was viewed favorably by municipal bond investors. This federal stimulus plan is expected to add liquidity to state and local municipalities, and other areas of the municipal market most affected by the pandemic. Not only did the stimulus plan calm credit concerns, it also stimulated demand for tax-exempt income as individuals anticipated increases in federal tax rates.

The municipal bond market continued to benefit from strong demand for tax-exempt income while supply levels remained manageable. While much of the current rhetoric out of Washington is focused on increasing the corporate tax rate to 28% to help cover the cost of the infrastructure plan, the prospects of higher individual taxes created a demand component that caused municipal yields to dislocate from the broader markets. Demand for tax-exempt income outpaced the supply of bonds and, as a result, municipal yields reached historically rich levels during the quarter. While the supply of municipal bonds has been manageable, the market is monitoring the possibility that issuers will once again be able to advance refund outstanding tax-exempt debt with new tax-exempt debt, which could alter the amount of supply of tax-exempt municipal bonds going forward. We would expect demand for tax-exempt bonds to continue, but richer valuations may cause some investors to temper their demand.

Municipal credit continues to be resilient. Municipalities have a long history of low defaults, even in the worst of times, especially among those issuers that have a rating from one of the major rating agencies. This past year has proven no different. While the market has experienced an uptick in defaults, they have largely been concentrated in riskier sectors and by issuers that were never rated. We do not expect this to change. In addition to direct federal aid supporting municipalities, revenue collections continue to improve as the economy seems to be in an upward trajectory as vaccinations accelerate and the labor market improves. Municipalities have also benefited from low borrowing costs, increased investment returns, an improved housing market, and access to capital as the municipal bond market has been favorable for issuers. These fundamental improvements have created tremendous demand, especially for lower-rated issuers.

Though municipalities should benefit from a growing economy, there remain challenges for those credits hardest hit by the pandemic shutdowns. Airports, mass transit, and economies that depend on business travel are just a few of the areas that may take longer to recover. The federal government has infused unprecedented amounts of liquidity into the system to help the recovery. While we are quite constructive on the fundamental and technical aspects of the market, this has fostered a reduction in value. At certain points during the quarter, the reduction in municipal yields had caused municipals to become exceptionally rich, resulting in minimal relative value in tax-exempt municipal bonds. For individuals in the uppermost tax brackets, municipals should still appear attractive, but the corporate buyer may find better value in other taxable alternatives. This relative value dynamic will be important to monitor as it will affect the demand for municipals going forward. The municipal bond market is very dependent on retail demand. Should investors begin to see better relative value away from municipal bonds, this could create an environment of higher yields and greater volatility. We would likely view this as a buying opportunity.

For more detail on tax-exempt municipal bonds in the first quarter, see Newfleet's 1Q21 Municipal Bond Market Review on Virtus.com.

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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 Credit Suisse Leveraged Loan Index is a market-weighted index that tracks the investable universe of the U.S. dollar denominated leveraged loans. The Bloomberg Barclays U.S. High-Yield 2% Issuer Capped Bond Index is a market capitalization-weighted index that measures fixed rate non-investment grade debt securities of U.S. and non-U.S. corporations. No single issuer accounts for more than 2% of market cap. 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.