Q2 21 MULTI-SECTOR FIXED INCOME

MARKET REVIEW AND OUTLOOK

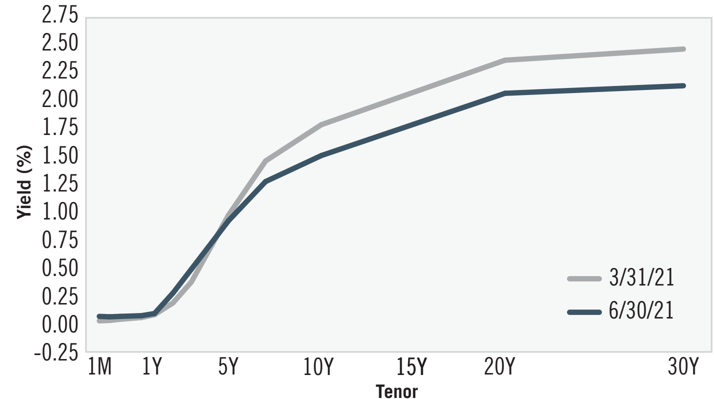
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

The world continued to make progress against the COVID-19 pandemic during the second quarter as vaccine distribution broadened, not only geographically, but also among differing age groups. While financial markets arguably recognized these improvements were coming months ago, the signs of returning toward a pre-pandemic normal were welcome, nonetheless. Global economic activity expanded, corporate earnings forecasts improved, and the debate on the implications for inflation dominated market commentary and, at times, market direction. The broad improvements in activity have led some to question the need and size for additional fiscal stimulus from the new administration, while narrow majorities in Congress suggest difficult negotiations lie ahead.

The economic recovery remains on track and the Federal Reserve (Fed) has now laid the groundwork to begin removing some of the extraordinary support it provided during the worst of the pandemic. As an example, it has announced that it would wind down its secondary market corporate credit facility by the end of the year. It's our expectation that the Fed will continue to moderate its support and announce a tapering of its asset purchase program ($120B of UST/MBS per month) in the second half of the year, most likely in August or September. The Fed remains committed to its communication strategy and has no desire to tighten financial conditions; and while a tapering should not be unexpected by financial markets, it's possible that there is a knee jerk reaction that we expect would be short lived. Regarding inflation, we believe that base effects related to the disruptions of early 2020 and global supply chain issues will continue to lead to elevated inflation readings in the coming months but expect those data points to prove transitory and likely to fade over the course of 2022. 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. It is our expectation that policymakers globally will remain supportive of a continued economic recovery.

The FOMC left its target rate for Fed Funds unchanged at a range of 0-0.25%, the rate that was set in late March 2020 in response to the pandemic. The Fed 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. Despite the recent uptick in inflation due to transitory factors, persistent shortfalls vs. 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, the U.S. Treasury rates increased marginally on the front end of the curve (3-years and in) and decreased throughout the belly and the long end. The 5-year Treasury yield fell 5 basis points (bps), the 10-year Treasury yield fell 26 bps and the 30-year Treasury yield was 31 bps lower.

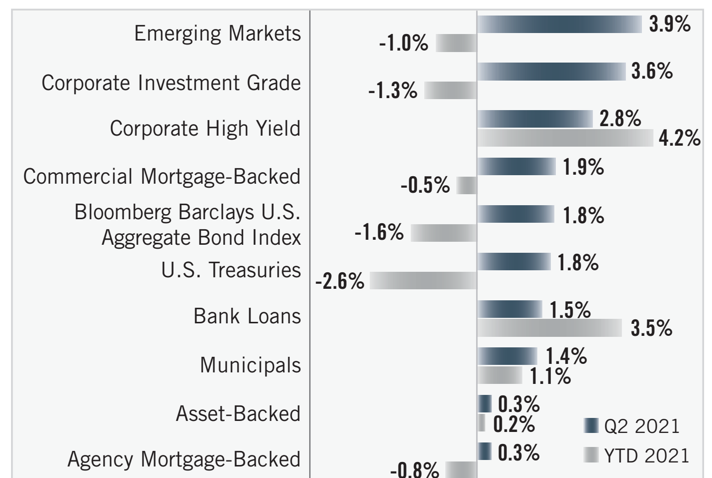
U.S. TREASURY YIELD CURVE



Source: Bloomberg L.P.

Financial markets generated mostly positive returns during the quarter, and we are continuing to find attractive investment opportunities across the many sectors of the bond market. 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 we expect will be a tailwind to growth in the coming quarters. We continue to take advantage of periods of market volatility consistent with the same multi-sector investment approach we've implemented for close to three decades.

FIXED INCOME SECTOR PERFORMANCE



Performance as of June 30, 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.

We continue to see value in spread sectors. While there is no doubt that the pandemic has proven disruptive to economies, we have seen a robust response from policymakers and signs of a return to normalcy. Our multi-sector approach to fixed income investing enables us to scan the bond market for the most attractive investment opportunities wherever they may be and is ideally suited for the current environment.

FIXED INCOME SECTOR PERFORMANCE

Most spread sectors outperformed U.S. Treasuries during the quarter led by rate-sensitive and or higher beta sectors, such as corporate investment grade, emerging markets, and corporate high yield. Within most sectors, lower quality generally outperformed, including within high yield, bank loans, and emerging markets. Longer duration also outperformed.

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

CORPORATE INVESTMENT GRADE

Investment Grade Corporate spreads ended the second quarter at what we would consider “all-time lows.” On a nominal basis, 80 bps of spread is the lowest since 2005. However, when spreads hit a low of +75 bps in 2005, the duration for the asset class was 5.8 years versus 8.7 years, currently. On a spread/duration measure, we are now at comparable levels to the mid-90s when spreads got as low as +55 with a duration of 5.8 years. Comparing spreads now versus then is complicated by the yield differential: 7% then versus 2.1% now.

Fundamentals are supportive of these tight valuations. For the full year, analysts are projecting revenue and earnings growth of 12% and 35%, respectively, and these figures have been trending higher throughout the second quarter. After recording $200B of fallen angels in 2020, there has been just $2.8B of fallen angels thus far in 2021. Year-to-date, S&P reports 18 rising stars versus six fallen angels. Moody’s reports 19 rising stars and two fallen angels. Within investment grade, upgrade/downgrade activity has been more balanced with upgrades outpacing downgrades by 13% (135 upgrades, 119 downgrades – S&P and Moody’s combined).

Investment Grade companies are still sitting on elevated liquidity after stockpiling cash in 2020, and while we are unsure where this excess capital gets deployed, we are seeing an increase in share repurchase authorizations and M&A activity. We would expect more shareholder friendly activity as earnings growth itself is sufficient to bring leverage back to pre-pandemic levels.

On the technical front, this has been an ordinary year for supply while demand drivers have been healthy. Foreign buying was more evident in the second quarter after stepping back in Q1 due to rate volatility. Mutual fund flows have been reliably positive even with ugly total returns in Q1. Those buyers have been rewarded, as total returns in the second quarter were 3.55% (vs -4.65% in Q1). As we look to the third quarter, we see a continuation of this technical environment as the pipeline for new issue is currently light, companies are sitting on elevated liquidity, and U.S. assets continue to provide an attractive yield on a hedged basis for foreign buyers.

As was the case after the first quarter, valuations remain the pinch point for the asset class, with fundamentals and technicals supportive. We’ve steadily reduced exposure to the asset class amid this rally to new tights. There remain a few pockets of opportunities within BBB rated credits, concentrated in the recovery industries and financials.

CORPORATE HIGH YIELD

The High Yield corporate market ended the second quarter of 2021 in positive territory again. CCC-rated securities continued to lead the way as investors’ desire for yield remained strong. Continued economic strength, strong first quarter earnings, and relaxed inflation fears all helped to propel the High Yield asset class to another positive quarterly return. In the first quarter, heightened inflation fears and a steepening U.S. Treasury yield curve negatively impacted returns of higher quality assets, but as those fears abated demand returned for all parts of the market, driving positive returns for each rating tier.

While primary issuance in the second quarter did not match the record-breaking pace of the first quarter, it was still a very active month with $140.5 billion of issuance, of which 60% was for refinancing. Year-to-date, we have seen almost $300 billion of issuance, which is on pace to easily surpass 2020’s banner year. The combination of low yields and a continued appetite for risk helped keep the capital markets open to corporate treasurers. Acquisition financing increased to 20% in the second quarter up from 10% in the first quarter. Over 80% of the second quarter’s issuance was a combination of refinancing and acquisition funding. Meanwhile, CCCs, as a percentage of issuance, increased to a historically high rate of 12.3%. With the economy continuing to reopen and corporate earnings improving, the default rate dropped from 5.50% at the end of the first quarter to 3.02% at quarter end. This is a 3.50% drop from the post-crisis high and is expected to continue to decline sharply through the end of the year.

Valuations in terms of credit spreads remain either at or near historic lows in High Yield. After quarter-end, the Index yield declined to its all-time low while spreads remain at pre-global financial crisis levels. Despite extended valuations, we remain positive on the asset class given the strong fundamental back drop and attractive valuations relative to other fixed income asset classes.

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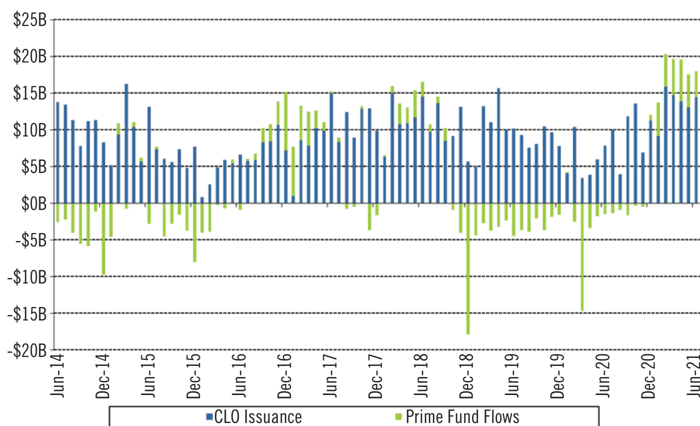
BANK LOANS

Bank loans posted solid performance in the second quarter driven by continued strong investor demand for duration management and income under a backdrop of an accelerating economic environment, low defaults, and limited loan supply calendar. The loan market had positive returns each month of the quarter, with the CS Leveraged Loan Index returning 1.44% and 3.48% for the second quarter and year-to-date, respectively. 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 (+3.42%) outperformed Bs (+1.52%) and BBs (+0.83%). Industries directly impacted by COVID-19 and heavy cyclical industries continued to claw back during the economic recovery, while more defensive areas lagged. Industries such as metals/minerals (+3.95%), cosmetics/toiletries (+3.81), and oil and gas (+3.36) outperformed, while utilities (-0.17%), food and drug retailers (+0.43%), and radio and television (+0.44%) lagged during the quarter.

Technical conditions (supply/demand) remain constructive. June was the seventh straight month of inflows. Year-to-date, inflows now total over $20 billion and exceed 2020 outflows of $19 billion. Collateralized loan obligation (CLO) issuance continued to be robust with approximately $39 billion for the quarter. At $78.9 billion of YTD issuance, the market is on track to exceed the record $129 billion issued in 2018. Institutional demand for very short duration income is not dissimilar to retail, but increased supply, capacity constraints at the rating agencies, and LIBOR cessation in the near term could create some volatility and spread widening.

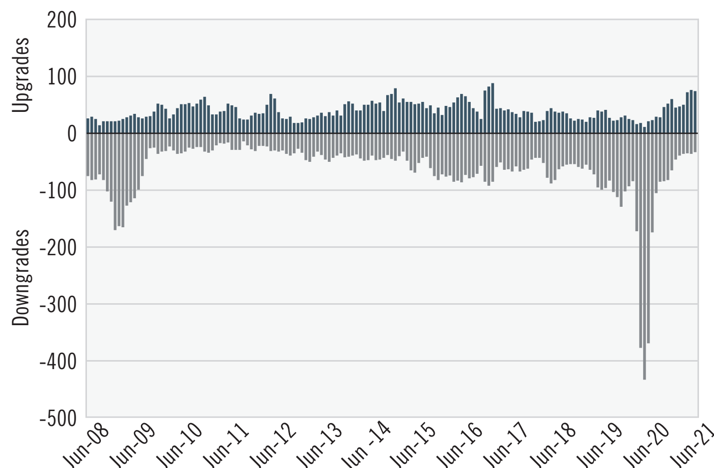
MONTHLY EST. INSTITUTIONAL CASH FLOWS



Data through June 30, 2021.
Source: LCD, an offering of S&P Global Market Intelligence.

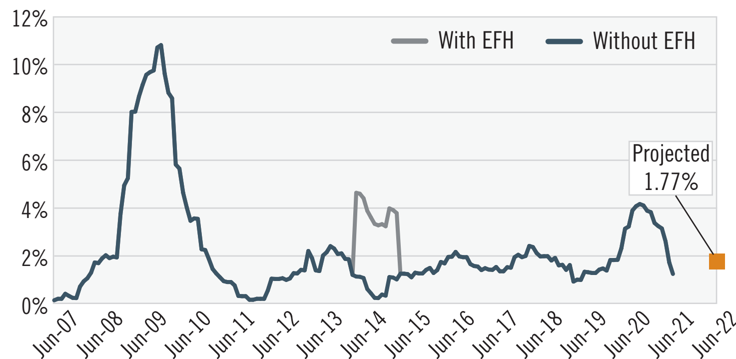
The fundamental environment is benign with supportive monetary and fiscal policies, open capital markets, credit upgrades exceeding downgrades, and the conclusion of a strong 1Q earnings season. We are seeing top line growth, realized cost savings, and the pass-through of higher input costs. After peaking at 4.17% in September 2020, the loan market default rate has declined for nine straight months to 1.24% in June. Further, roughly 61% of defaulted loans come from only two industries – energy and retail. With minimal distressed loans in the market, open capital markets access, and an improving macroeconomic backdrop, we expect the default rate to decline further and remain below the historic average of 2.9% for the next twelve months.

ROLLING 3-MONTH COUNT OF LOAN RATINGS UPGRADES VS. DOWNGRADES



Data through June 30, 2021. Source: LCD, an offering of S&P Global Market Intelligence; S&P/LSTA Leveraged Loan Index.

U.S. LEVERAGED LOAN DEFAULT RATE (FORECAST THROUGH JUNE 2022)



Data through June 28, 2021. Chart shows historical and projected default rates. EFH = Energy Futures Holdings. Source: LCD, an offering of S&P Global Market Intelligence.

Our expectation is for the 2Q earnings season to reflect another very easy comparable and continued improved credit statistics but may be peak year-over-year earnings growth. We are beginning to focus on the impact an economic

environment with less federal support and the need to bring back costs might have on borrowers, especially as the single B risk cohort now accounts for 62% of the market and lending standards have loosened.

Loan market prices were up 0.04% to 98.4 in June – the highest since October 2018. Although 25% of the market is priced at par or higher, we believe the combination of a fuller primary market calendar and limited remaining refinancing opportunities should make refinancing risk manageable in the near term. Loan spread to a 3-year life tightened to L+417 in June. For context, while we remain tight to historical (post-GFC) averages (L+532), we have seen valuations tighten to mid L+300s during the last rising-rate environment of 2017-2018.

Update on LIBOR: The Commodity Futures Trading Commission's Market Risk Advisory Committee Interest Rate Benchmark Reform Subcommittee has voted to recommend a market best practice starting July 26th for switching interdealer trading conventions from LIBOR to SOFR for U.S. dollar linear interest rate swaps. The loan market is watching this shift as a possible catalyst to develop a SOFR term structure or curve, which might accelerate the adoption of the new benchmark rate. Ford has announced that it will refinance a $15.4B credit facility using SOFR as its base rate – the first SOFR loan of its kind and second non-LIBOR loan after Duluth Holdings issued a Revolving Line of Credit using the Bloomberg 3-month Short Term Bank Yield Benchmark (BSBY).

We remain constructive on loans for the balance of the summer (continued coupon clip expectation) based on what we expect to be a strong 2Q earnings season, still improving macroeconomic backdrop and credit trends, and continued fiscal and monetary support. Technical conditions should also remain positive with strong retail and institutional demand offsetting net new supply (notwithstanding what we believe will be a continuation of strong new issuance for the remainder of the year).

EMERGING MARKET DEBT

Emerging market (EM) sovereign debt posted a 3.93% total return in the second quarter driven partly by tighter spreads, but even more so by falling U.S. treasury yields. Sovereign index (JPM EMBI Global Index) spread levels moved lower by 9 bps during the period, ending the quarter at 309 bps. Meanwhile, U.S. treasury yields moved markedly lower with the 10-year yield falling 27 bps, reversing some of the rise in yield we saw in the first quarter, and ending the quarter at 1.47%, still well above the beginning of the year 0.91% rate on the 10-year.

The overall EM index yield at 4.62% is low from a historical context, but attractive on a relative basis versus other fixed income alternatives, globally. The index spread at quarter-end was also on the tighter end of historical valuations and well inside the five- and 10-year average index spread of 357 bps and 360 bps, respectively.

Some EM performance highlights in the quarter:

> High yield bonds outperformed with a 5.16% total return. High yield sub-index spread ended the quarter 32 bps tighter at 586 bps. Investment grade EM total return was 3.17% with the sub-index spread at 147 bps, or 2 bps wider at the end of the quarter.

> CCC and B rated buckets produced outsized returns of 6.88% and 6.03%, respectively. Longer duration bonds outperformed as well with the +10-year maturity bucket returning 5.82% in the quarter.

> Ecuador index returned 46.8% on the back of an unexpectedly market friendly election result. Zambia (11.5%), Tajikistan (11.3%), Angola (10.5%), and Cameroon (10.4%) also produced double-digit total returns.

> Lebanon (9.5%), Costa Rica (6.8%), Sri Lanka (7.9%), South Africa (6.7%), and Turkey (7.0%) were also notable outperformers.

> Laggards in the period included Belarus (-3.3%), El Salvador (-5.0%), Suriname (-8.0%), Venezuela (-2.6%), and Papua New Guinea (-1.0%).

> EM corporate returns, which have shorter duration, underperformed the sovereign index with the main corporate index (JPM 's CEMBI Diversified) returning +2.12% in the second quarter. Similar to the sovereign index, low quality and longer duration bonds outperformed.

Local market returns were positive as well but lagged the hard currency sovereign index by 39 bps. The main local market index, the JPM GBI-EM Global Diversified, returned 3.54% for the period. Brazil (+14.3% return) and South Africa (+10.7%) were standout performers on the back of higher rates in the former, and progress on reforms in the latter. Chile (-6.9%) and Peru (-3.7%) were the worst index performers reflecting heightened political and social risks, and—specifically with regard to Peru—an unfavorable presidential election outcome.

Gross EM debt issuance, both sovereign and corporate, remained high during the second quarter with borrowers looking to close funding gaps as well as take advantage of the low-rate environment and retire higher cost debt. Meanwhile, retail investor flows into EM bonds have been healthy year-to-date and we expect this trend to continue given relatively attractive yields.

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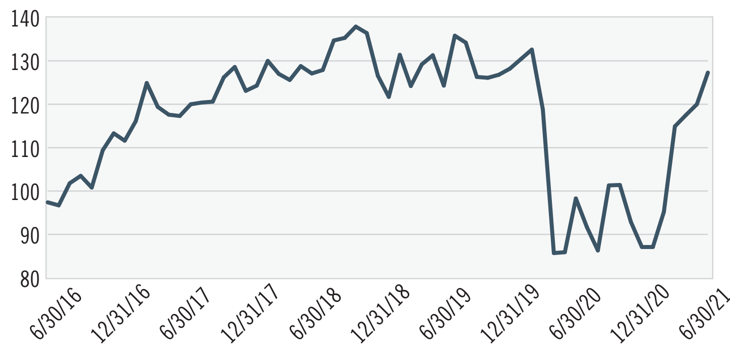
In terms of our outlook moving forward, slower rollout of vaccines across EM will contribute to a more prolonged and shallow recovery. We expect to see permanent scarring in the form of higher government debt-to-GDP levels and weakened debt service ability throughout EM resulting in downward pressure on sovereign credit ratings. Rising inflation is also more of a problem for many EM countries, where, in contrast to developed markets, food and fuel costs are a larger percentage of the CPI basket. As result, there is growing pressure on EM central banks to begin hiking local rates despite an incomplete economic recovery. We have already seen rate hikes from Brazil, Russia, Mexico, and Hungary among others. Support from multi-laterals will remain generous; for example, we expect the IMF to implement its plan to increase special drawing right (SDR) allocations by the end of August 2021 which will boost international reserves across emerging market countries.

SECURITIZED PRODUCT

Risk assets performed very well during the second quarter as subordinate securitized debt outperformed its high-quality peers. Spreads tightened across the board for all structured product with junior tranches tightening more materially. Based on the Bloomberg Barclays US Aggregate Bond Index, total returns for the quarter were as follows: ABS +0.34%, CMBS +1.86%, and MBS +0.34%. From a technical perspective, mutual fund flows have dominated the front end of the yield curve in search of short duration assets. For the most part, securitized product is a short duration asset that has historically yielded more than corporates After a lull for the better part of 2020, issuance is on pace with and will probably exceed 2019 issuance levels. However, given the fund flows to the short part of the curve and net issuance levels for all sectors, which we would describe as moderate, we believe the technical picture for securitized debt will continue to be strong for the second half of the year.

With respect to consumer fundamentals, the unemployment rate continued to trend lower during the quarter, declining from 6.2% in March 2021 to 5.8% at the end of Q2. With over 9 million job openings and the federal unemployment stimulus payment expiring in September, we envision the unemployment number to trend lower. From a consumer delinquency and loss perspective, our pool data continues to perform exceptionally well aided by the federal stimulus payments. Looking ahead, as stimulus dollars run-off for all states this September, we believe federal dollars will be supplanted by market dollars in the form of increased hiring and ever-increasing wage growth. Consumer confidence (see graph) continues to trend higher as evidenced by the latest reading from the Federal Reserve, which reached levels last seen in 2019. In addition, the U.S. personal savings rate sits at historically high levels. Households are sitting on $3 trillion of excess cash that, if deployed into the broader economy, will continue to drive growth and asset appreciation.

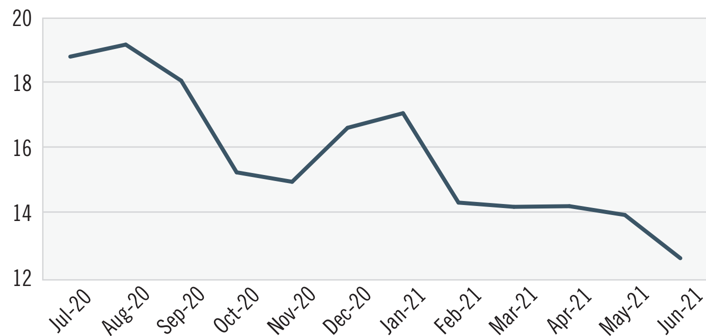
CONFERENCE BOARD CONSUMER CONFIDENCE INDEX



Source: Bloomberg

The commercial mortgage market is a bifurcated market with respect to fundamental performance. Property types such as multi-family and industrial properties have performed extremely well since the crisis. Hotel and certain retail property types (e.g., low to mid-tier malls) have underperformed since the pandemic. However, hotel occupancy rates continue to trend upward as leisure travel has returned and business travel slowly makes its way back. Currently, the office segment continues to perform well due to long-term leases that are in place. However, the verdict is still out on how office properties will perform in the medium term as underlying tenant leases begin to roll, especially in high-cost markets. Improved fundamental performance has seen a follow through in the credit markets as evidenced by the significant rally in CMBS risk tranches over this past quarter. Over the past quarter, the delinquency profile, even within the hospitality sector of CMBS, continued to improve.

HOTEL CONDUIT LOANS 60+ DELINQUENT



Source: Bloomberg

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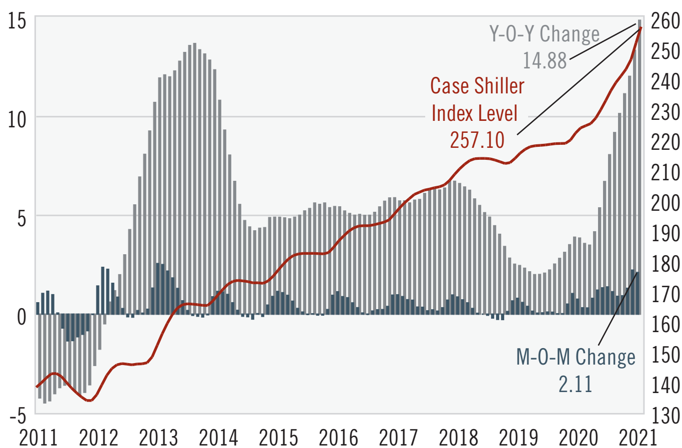
The housing market continues to climb and, in turn, so does the performance of the non-agency residential mortgage-backed securities market. We see strong demand for all residential mortgage products. The chart below demonstrates the strength of the housing market even during the pandemic. The latest report shows a record 14.9% year-over-year gain for April 2021. It will be interesting to watch the residential market play out in the second half of 2021 as government stimulus and assistance begin to wind down.

S&P CORELOGIC CASE-SHILLER 20-CITY COMPOSITE HOME PRICE NSA INDEX



Data through April 30, 2021. Source: Bloomberg

It's fair to say that we are currently in a coupon clipping environment within the securitized market. Spread levels for most asset types are at or near historical lows. Investors continued to reach for yield during the second quarter as we witnessed troubled assets, such as hotel and aircraft lease spreads, rally during the quarter. In the second quarter, we focused our efforts on the new issue markets, which experienced very strong demand across all securitized sectors. Fund flows continue to dominate the short part of the yield curve and as a result there were too many dollars chasing too few assets. 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 with respect to taking on credit risk. We continue to monitor and adjust the portfolio based on the ever-changing economic news and, more importantly, to take advantage of any future credit dislocations.

TAX-EXEMPT MUNICIPAL BONDS

During the quarter, the municipal bond market continued to benefit from steady inflows into municipal bond funds, while new issuance remained manageable. This supply/demand imbalance, which has persisted for much of this year, once again provided a favorable backdrop for another quarter of solid returns, with the Bloomberg Barclays Municipal Bond Index posting a quarterly return of 1.42%. With municipalities continuing to benefit from record amounts of federal stimulus and an improving economy, investors are continuing to embrace risk. Longer-dated and lower-rated bonds produced the best relative performance over the period.

The enormous amount of federal stimulus that has been distributed across the country and the prospects of higher taxes shined a spotlight on the municipal bond market, driving steady demand for tax-exempt income. While Washington seems focused on increasing various taxes to help cover the costs of this stimulus and a possible infrastructure plan, investors have been pouring money into tax-advantaged municipal bond mutual funds at a record pace. The $60 billion of fund inflows that municipal bond mutual funds have now seen through the first six months of this year, as reported by Lipper, has created tremendous demand for municipal bonds. This demand has outpaced supply as municipalities appear on the sidelines waiting for the possibility that Washington will restore their ability to advance refund outstanding tax-exempt debt with new tax-exempt debt, or reinstate a Build America Bond-like program to help fund the large infrastructure plan that is being proposed. In addition, municipalities are benefitting from a rebound in tax collections as the economy rebounds from the pandemic, also minimizing the need for municipalities to issue new debt. While we expect demand for tax-exempt bonds to continue, higher valuations may cause some investors to temper their interest, especially if tax increases are not as steep as expected.

As the economy reopens, municipal credits are benefitting from improved tax collections as individuals are spending, travelling, and buying homes. The federal government has infused unprecedented amounts of liquidity into the system to aid the recovery, and municipalities have greatly benefited. The improving economy and the federal support to both state and local municipalities during the pandemic have helped to avert possible credit issues, allowing municipalities to replenish their rainy-day funds and push most credit concerns aside for now. There appears to be an absence of municipal credit concerns, as the market is experiencing record flows into long-term and high yield funds as investors search for income. In addition, bond rating agencies seem increasingly favorable on credit with many issuers experiencing upgrades and most sector outlooks returning to stable. While we believe that market fundamentals have improved dramatically, valuations of lower-rated credits, in many cases, are approaching overvalued levels. Credit

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spreads, or the additional yield received for buying a lower-rated bond, have returned to pre-pandemic levels as a result of tremendous demand for yield, and now seem priced to perfection. As we take a longer-term view on our purchases, we believe that pension challenges, climate change, and other revenue challenges will likely resurface, thereby creating pricing volatility.

While much of the past quarter was a mirror image of the first, where strong demand of tax-exempt income was the driving force for municipal bonds, we look to Washington for direction in the second half of the year. The Biden administration continues to have an ambitious agenda as they look to pass a plan to upgrade the nation's aging infrastructure. For a market that has been starving for supply, this may be the answer as municipalities look to finance projects with tax-exempt bonds. While we still hold out hope that some form of infrastructure bill gets passed, it is not a guarantee given the connection with other progressive initiatives. Another important consideration to the municipal bond market will be how this ambitious spending gets funded. Currently, the market is pricing in the likelihood of higher taxes, which has been the driving force for richer valuations, resulting in minimal relative value versus other fixed-income investment alternatives. This relative value dynamic needs to be monitored closely as it will likely impact municipal demand going forward, especially if taxes do not increase as aggressively anticipated. Should investors begin to see more attractive relative value away from municipal bonds, this could create an environment of higher municipal yields and greater volatility, signaling a potential buying opportunity. We still believe that our higher quality investment strategy, distributed across multiple sectors of the market, should provide good relative performance over the long term.

For more detail on tax-exempt municipal bonds in the first quarter, see Newfleet's 2Q21 Municipal Bond Market Review on Virtus.com.

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.

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