NEWFLEET ASSET MANAGEMENT

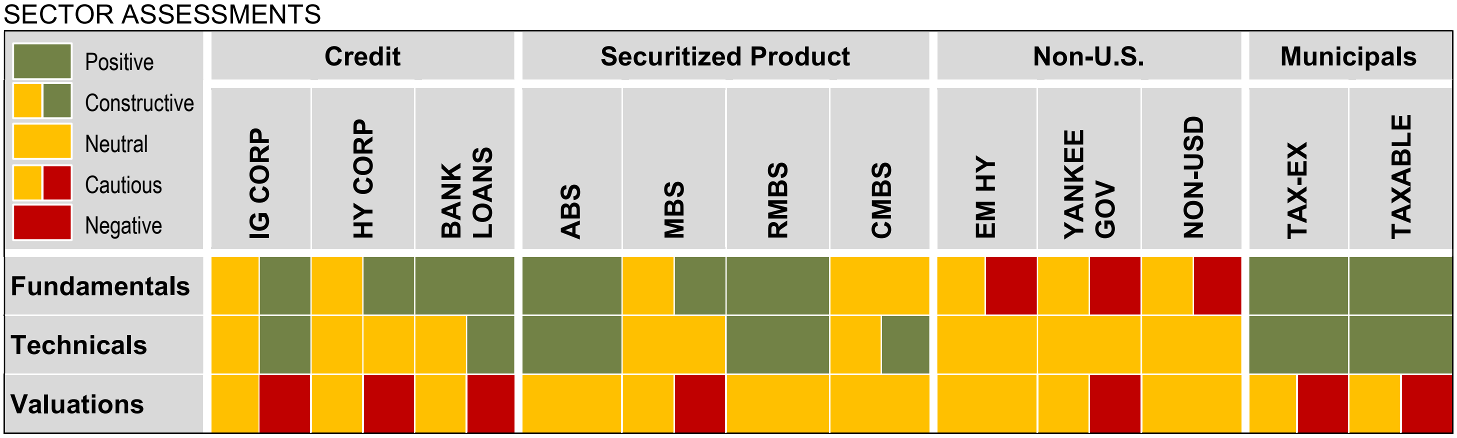
Fixed Income Sector Review

As of October 31, 2021

OBSERVATIONS ON THE MACRO ENVIRONMENT & MARKET CONDITIONS

- For the past two months we noted that while we still saw the global macro backdrop as neutral, we were compelled to discuss growing odds of a less favorable backdrop developing.
- We also reiterated our strategy, which was (and remains) to earn the carry from fixed income assets as we expect rates and risk spreads to remain in roughly well-defined ranges – albeit still on the tight side of those ranges.
- Since the beginning of September, the Bloomberg Agg has dipped by 89 bps while the S&P 500 gained another 2.03% and the 10-year US Treasury yield increased by about 25 bps. We interpret this to mean that despite continued equity market strength, tight credit risk spreads leave credit assets vulnerable to duration (higher Treasury yields).
- The key interest rate driver comes from our view that inflation, while transitory over the long-term, may not be so over the near-term. Over the long-term, economies will build capacity (increase supply) to alleviate shortages and lower prices. However, over the short-term, there will be areas with no (or fewer) transactions at any price because higher prices are supply chain-driven – examples include natural gas in the EU, port back-ups for ships (in) and trucks (out), semi-conductors for auto production, etc.
- We are holding our year-end rate forecast at the mid 1% range, which represents a slight reduction from our previously long-held view of a high 1% range.
- We still see China's growth as the primary source of broader event risk. We think growth estimates are too high and that investors are underestimating the magnitude of ripple effects emanating from further real estate disruptions to broader measures of economic activity. In a nutshell, we have not had any exposure to China for a while.
- Overall, we still do not anticipate a recession, because government policy makers remain on high alert and developed country inflation remains well- contained.

SECTOR ASSESSMENTS



Newfleet's assessments of non-government spread sectors as of October 31, 2021. Assessments are determined by analyzing a sector's fundamental data, technical indicators, and relative valuations. Sectors (l to r): **Credit**: Investment Grade (IG) Corporate Bonds, High Yield (HY) Corporate Bonds, Bank Loans. **Securitized Product**: Asset-Backed Securities (ABS), Agency Mortgage-Backed Securities (MBS), Non-Agency Residential MBS (RMBS), Non-Agency Commercial MBS (CMBS). **Non-U.S.**: Emerging Markets HY, Yankee Government, Non-U.S. Dollar. **Municipals**: Tax-Exempt, Taxable.

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SELECT SECTOR HIGHLIGHTS

Investment Grade Corporate Bonds	• With nearly 90% of constituents reporting, third quarter sales and earnings growth for the S&P 500 stands at 19% and 41% year-over-year, respectively. Earnings are beating estimates by nearly 10%, a high magnitude by historical levels. • We are surprised by the resiliency of these firms with the backdrop of supply chain constraints. Earnings growth estimates for Q4 and 2022 have not declined and companies are not providing negative guidance at a rate that is out of line with historical averages. • Spreads have barely budged over the past six months, and it is hard to foresee that changing in the final two months of the year. Spreads widened 4 bps in October to 87 bps and have been range bound between 80-90 since mid-April. • Heavy gross ($143 billion) and net ($68 billion) supply for the month met with uneven flows that oscillated between positive and negative weeks as investors faced rising yields in the first two weeks of the month. However, we are now entering a seasonally favorable portion of the calendar with low supply.
High Yield Corporate Bonds	• Fundamentals were broadly positive in October as the third quarter earnings season started off well; however, dispersion across industries is widening with inflation and pricing power in focus. Non-COVID-driven volatility is rising in certain industries such as retail, restaurants, and cable, which traded lower due to constraints around logistics, labor, and increasing competition, respectively. • October saw the least amount of new issuance of 2021 with just $30.2 billion of gross issuance across 50 issues. A third consecutive month of inflows ($1.4 billion) combined for a supply shortfall of -$3.4 billion for October. Refinancing remained the largest use of proceeds, but acquisition finance/LBO issuance continued to increase from 38% in September to 42.7% in October. • High Yield finished the month of October with a small negative return of -0.17%. There was little variation across rating tiers as BBs, Bs and CCCs also finished with slightly negative returns at -0.14%, -0.15% and -0.21%, respectively.
Bank Loans	• Loan market prices, though down slightly in October (0.07%), were more than offset by coupon (.34%), providing a positive 0.27% total return. Strong demand outpaced a downshift in new supply as markets repriced rate hike expectations and the 10-year Treasury yield increased to 1.55%. In this environment, loans bested Investment Grade (up 0.25%), High Yield (down 0.18%) and Treasuries (down 0.12%). • At 0.20%, the loan default rate is the lowest since December 2011 and approaching the record low of 0.15% in June 2007. • SOFR continues to gain momentum in the market. As SOFR-based loans arranged by JP Morgan and Bank of America successfully cleared, Onex Credit Partners priced a CLO in which $84 million of the AAA slice of the structure was priced using 3-month SOFR as the base rate. We view this as a positive step in the CLO market and, in turn, future demand for the loan asset class. • We are modeling above-trend economic growth in 2022 and as such will look to remain fully invested. However, despite the favorable backdrop, our positioning will remain at market risk as the current thin valuation differential between B risk and BB risk (L+113) falls under historical averages including post-COVID (L+164), post-Great Financial Crisis (L+195), and all time (L+235).
Securitized Product	• The front end of the U.S. Treasury curve moved sharply higher during October, causing short duration products to post negative returns across the board. However, spreads for most securitized products continued to remain firm versus U.S. Treasuries. The more credit sensitive components of securitized outperformed higher quality counterparts and posted a positive return for the month. • Overall, spreads for securitized products are still compelling compared with comparable-duration corporate bonds and risk-free assets.

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	• Most securitized spreads have stayed near all-time tights since June. However, we did see non-agency RMBS widen due to a large amount of issuance during the month of October. The threat of higher mortgage rates also added to pricing pressures. We are looking to take advantage of this technical. • We continue to emphasize asset-backed and non-agency mortgage-backed securities within our portfolio. This is driven by the strong performance of the U.S. consumer and demand for residential housing assets.
Emerging Market Debt	• The JPM EMBI Global (EMBIG) total return for the month was slightly positive at 0.06%, bringing the year-to-date return at 10/31/21 to -1.47%. Investment grade returns outperformed high yield returns by 54 bps (+0.28% vs -0.26%) as a flattening yield curve saw 30-year US Treasury yields fall 11 bps while short and intermediate yields rose. • Our EM exposure remains near historical lows in our portfolios as we remain more constructive on U.S. corporate credit sectors, including floating rate-based leveraged loans. In addition, despite material underperformance from local market debt, we still do not see significant opportunity there and retain our view to hold no exposure. Monthly retail fund flows were negative over the past four weeks while new issue volumes were average. • Overall, EM index spread remains in the middle of its recent 300-350 bps range and we maintain our stance of being better buyers at the top of that range. Index spread valuation is relatively rich on a historical basis versus the 5-year average spread of 353 bps and the 10-year average spread of 358 bps.
Municipal Bonds	• October marked the first time in over 6 years that municipal bonds reported three consecutive months of negative returns. The last time the market saw over four months in a row of negative returns was Sept 2010 – Jan 2011. • Municipal bond-friendly provisions such as tax-exempt advance refundings, an expansion of bank-qualified bonds, and Build America Bonds (otherwise known as direct-pay bonds) failed to make the final cut in the $1.2 trillion infrastructure bill. This along with a proposed 15% corporate minimum book tax may pose some potential risk to the market. • However, historic demand for municipal bond funds continues. Lipper reported the 34th straight week of positive inflows, with combined weekly and monthly inflows of $397 million for the period ending October 27th, increasing YTD inflows to $91.4 billion.

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