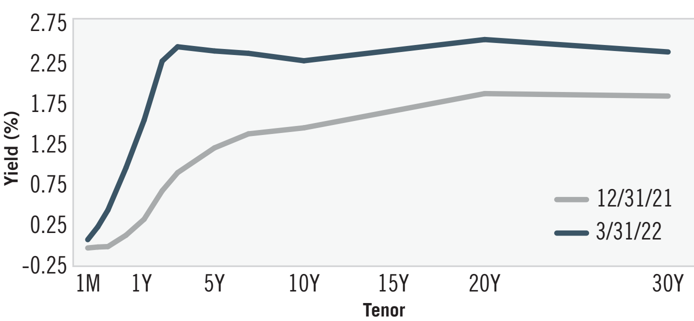
Q1 22 MULTI-SECTOR FIXED INCOME
MARKET REVIEW AND OUTLOOK

Volatility returned to global markets during the quarter. The pandemic remained in the headlines while cases flared and eased. The latest variant, Omicron, proved to be generally less severe, though certain global regions were more impacted than others. China's "zero COVID" policy came under scrutiny given its potential impact on supply chain disruptions that exacerbate inflation. A secondary market shock occurred as Russia invaded Ukraine. The military operation on the ground in Ukraine resulted in another supply shock, this time centered on commodities. The ultimate economic impact of this latest shock remains largely unknown. However, most forecasts indicate lower growth and higher, more prolonged inflation.

The Fed and other major central banks shifted to a more sharply hawkish tone in response to elevated inflation metrics. As expected, the Federal Open Market Committee (FOMC) completed its asset purchase program and raised its policy rate for the first time since 2018, with more rate increases likely to come. It also signaled that the Fed is likely to begin reducing its $8.9 trillion-dollar balance sheet as soon as its next meeting in May.

Markets have priced in significant Fed monetary tightening over the rest of the year. As a result, the U.S. Treasury curve shifted higher and flattened, which inflicted losses on fixed income assets. The 5-year Treasury yield jumped up 160 basis points (bps), the 10-year Treasury yield went up by 83 bps, and the 30-year Treasury yield moved 55 bps higher.

U.S. TREASURY YIELD CURVE

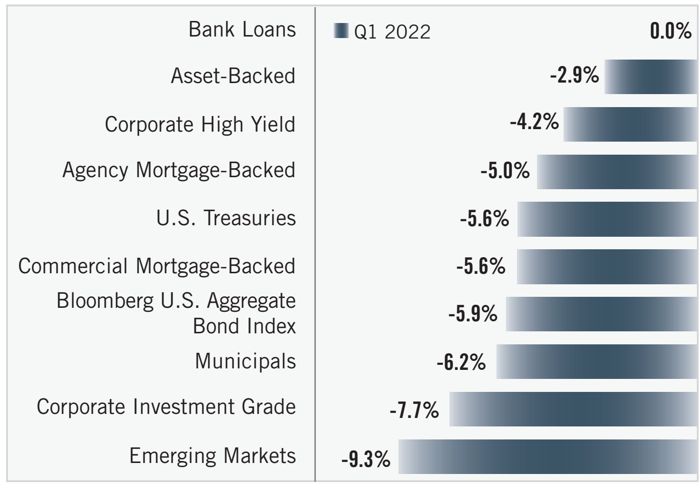


Source: Bloomberg L.P.

Despite the quarter's volatility, we see value being restored across most of the fixed income sectors in which we invest. Economic growth is expected to remain above-trend, corporate earnings are expected to keep growing, unemployment remains low, and the consumer and housing markets remain well supported. Near-term recession is not our base case. It's our expectation that supply chains will heal over time and the Fed will be successful in restoring price stability.

As the markets digest global developments, we continue to believe active sector and issuer selection is critical to take advantage of market volatility as it arises. Our approach to fixed income – the approach we've implemented for close to three decades – enables us to scan the bond market for the most attractive investment opportunities and is ideally suited for the current environment.

FIXED INCOME SECTOR PERFORMANCE



Performance as of March 31, 2022. Sources: J.P. Morgan: Emerging Markets (EMBI Global), Corporate High Yield, Bank Loans; Bloomberg Municipal Bond Index: Municipals; Bloomberg U.S. Aggregate Bond Index: All other sectors.
Past performance is no guarantee of future results.

FIXED INCOME SECTOR PERFORMANCE

Spread sectors underperformed U.S. Treasuries, and volatility in the fixed income markets increased both due to a more hawkish Fed policy and the Russian invasion of Ukraine. With the spike in U.S. Treasury yields, less interest rate-sensitive sectors such as high yield bank loans and other shorter-duration asset classes, including asset-backed securities (ABS), generally outperformed on a total return basis.

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

CORPORATE INVESTMENT GRADE

With negative total returns of -7.8%, Q1 2022 was the worst first quarter in the past forty years. The asset class is long duration and bore the brunt of rising interest rates. We find ourselves contrasting how new and volatile this market feels with how "boring" some key variables are: spreads are average, supply is unchanged, flows are neutral, and fundamentals are plateauing.

One could read this as the market handling the unwind in rates better than we expected, or one could say the market is paralyzed by this paradigm shift, with "go-to cash" off the table due to 7% inflation. At Newfleet, we took advantage of widening spreads in mid-March by opportunistically adding select investment grade (IG) credits, but the opportunity was shorter-lived than we expected, with spreads quickly retracing much of the YTD move in the final two weeks of the quarter. We will remain flexible in our approach for the remainder of the year.

Credit metrics returned to pre-COVID levels in late 2021, and the pace of improvement has now slowed. For the S&P 500® Index, fourth quarter earnings came in 6% ahead of expectations with 30% year-over-year growth. Perhaps surprisingly, the market has not reduced earnings expectations for 2022. In fact, earnings estimates for the full year have risen from 8% to 9%. This growth is back-half weighted, since the market anticipates a more difficult comp and margin environment in Q1, with projections for 5% earnings growth. The ratings agencies have taken stock of the credit repair done over the past year and have upgraded IG credits at 6x the rate of downgrades.

Robust supply is unique to the IG market and has contributed to the asset class's underperformance in Q1. Gross and net supply tallied $509 billion and $226 billion in Q1, down 3% and up 4%, respectively. This stands in contrast to high yield and leveraged loans, where supply is materially lower YTD. Financial issuers have been especially keen to issue ahead of rising rates, and while the new issue concessions were very high in March (>10 bps versus 3 bps average), the market was open.

On the demand side, we have modest outflows from mutual funds – and frankly, we are surprised it is not much worse, considering the awful total returns. On the long end, domestic yield buyers are stepping in somewhat, with yields north of 4%. The foreign buyer is a big question mark for the remainder of the year as hedging costs rise and global yields move largely back into positive territory. The U.S. market is no longer the last bastion for yield.

Spreads widened from 92 bps at the start of the year to a peak of 144 bps in mid-March before retracing 55% of the YTD move wider in the final two weeks of the quarter. Spreads ended the quarter at 115 bps – equivalent to the five-year average. Some value has been restored to the asset class, though uncertainty has picked up and total returns have been ugly, which may lead to future outflows. We opportunistically added to our IG positions in Q1 amidst the volatility and intend to pursue a similar strategy in the second quarter. We favor BBB rated securities and financial industries.

CORPORATE HIGH YIELD

The high yield index moved lower during the quarter as rates rose and spreads widened, resulting in a total return of -4.8%. A combination of rising Treasury rates and 42 bps of credit spread widening drove the weak performance. Spreads hit a peak north of +400 bps in mid-March before rapidly grinding lower into quarter-end and retracing about two-thirds of the spread widening. Single-B rated bonds outperformed, while the more rate sensitive double-B rated bonds were harder hit from the rise in rates. Triple-C credit spreads widened the most, dragging down performance.

The trajectory in fundamentals was generally favorable, with aggregate credit metrics hitting pre-COVID levels; however, some individual firms struggled to deal with rising input costs and supply chain challenges. High yield has a greater exposure to commodity-related firms, which helped drive some relative outperformance versus other fixed income sectors. Relative industry performance was driven by the move in oil and gas prices, which resulted in energy-related sectors outperforming. Leisure also outperformed as consumers upped their spend on travel and experiences amid the post-COVID reopening. Wireless and food & beverage lagged due to long-dated maturities from large issuers such as T-Mobile and Kraft Heinz, which fared poorly with the rise in Treasury rates.

Technicals deteriorated as the sector experienced consistent and heavy retail outflows. However, the impact of this was muted as supply dropped sharply after early January, which left supply and demand more balanced. February and March printed only a combined supply of $20 billion. In contrast, the second half of 2021 averaged $30 billion per month.

On a positive note, high yield yields are nearly back to levels more consistent with historical averages. Convexity has improved, with lower dollar prices on bonds and much less paper trading to near-term calls. Despite this, we've become more negative on the asset class given the recent rally in spreads despite a forthcoming aggressive tightening campaign from the Fed, and fundamentals that may be impacted from the Russia/Ukraine war.

During the quarter, we reduced exposures to industries facing more difficult competitive environments (wirelines, technology), along with industries challenged by margin pressures from rising input costs (manufacturing, airlines, retailers). We added to industries (such as leisure and energy) that will benefit from reopening dynamics and rising commodity prices, which we expect will persist.

BANK LOANS

The quarter got off to an encouraging start in January, only to see a sharp sell-off driven by the war in Ukraine that lasted from February 23rd to March 15th. The Fed's rate hike and hawkish stance on future rate increases compelled

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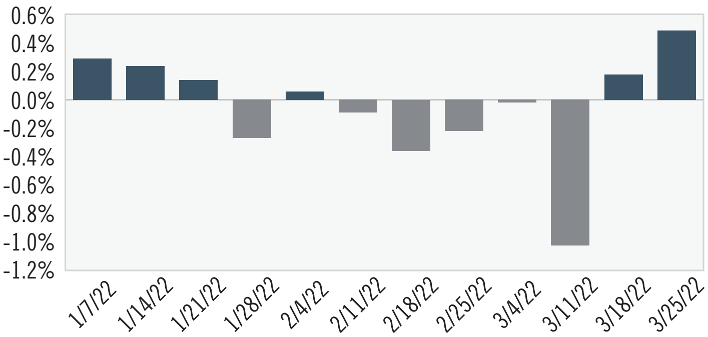
the market to renew its focus on inflation and rates, resulting in positive retail fund flows and a recovery of most of the war-related losses, though the quarter still finished below 4Q21 year-end levels.

U.S. LEVERAGED LOAN RETURNS, WEEKLY

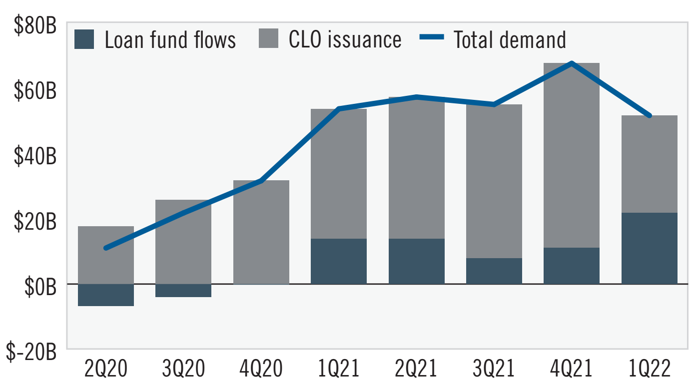


Data through March 25, 2022.
Source: Leveraged Commentary & Data (LCD), S&P/LSTA Leveraged Loan Index.

Given the impact of the Russia sanctions, commodity-sensitive industries such as oil & gas and metals & mining outperformed, while industries such as leisure, lodging, and gaming benefited from COVID reopening dynamics. On the other hand, inflation- and interest rate-sensitive sectors such as autos, furnishing, and food service saw some of the weakest returns. And the broader economic picture looks more uncertain, CCC-rated credits have underperformed YTD – a reversal of trends that have dominated since COVID.

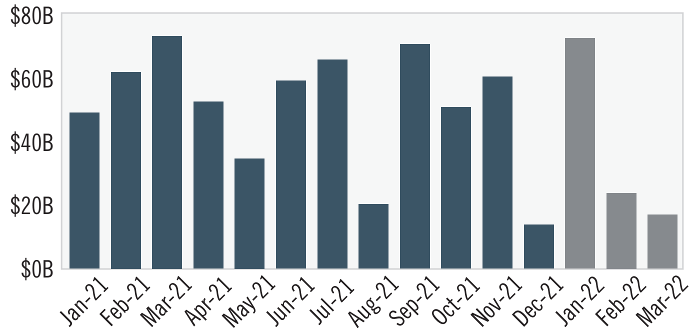
Technicals remained solid as the market renewed its focus on rates and the 10-year Treasury yield, with $22 billion of retail inflows coming into the market in 1Q. On the supply side, the market started at a record pace coming right off 2021's banner year, but momentum dwindled as the quarter wore on due to war-related volatility and slowing M&A deal flow.

U.S. LEVERAGED LOAN MARKET MEASURABLE INVESTOR DEMAND



Data through March 31, 2022. Fund flows data includes monthly reporters.
Sources: Leveraged Commentary & Data (LCD); Lipper.

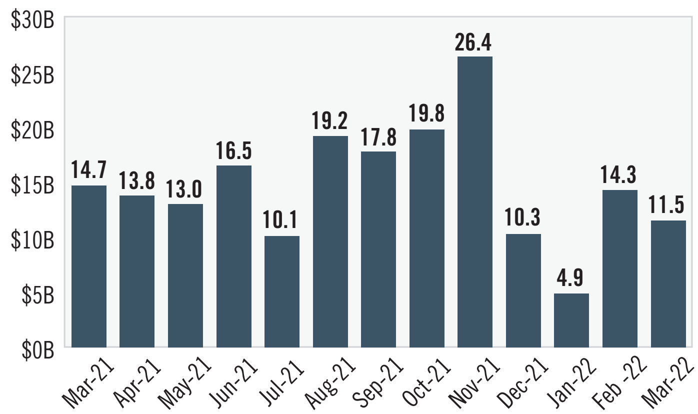
U.S. LEVERAGED LOAN ISSUANCE, MONTHLY



Data through March 31, 2022. Source: Leveraged Commentary & Data (LCD).

The CLO market has handily transitioned from LIBOR to SOFR, ramping up from $4 billion in issuance in January to $14 billion in February – near 2021's record pace. Issuance cooled off in March to $11.2 billion as the wider cost of liabilities put CLO equity returns under pressure, creating a more difficult environment for printing deals. Nevertheless, we still think CLO issuance will remain at reasonable levels, at around $8-10 billion a month.

CLO VOLUME



Source: Leveraged Commentary & Data (LCD).

Overall, fundamentals for loans remain solid: default rates are at a 10-year low, EBITDA is up low double-digits across the board, and leverage is down year-over-year. Interest coverage ratios have held strong so far, though rising rates may begin to have a negative effect on those metrics.

That said, fundamentals have likely peaked and are likely to modestly deteriorate – particularly for the lower-quality portion of the market with weaker interest coverage ratios that are more vulnerable to tightening capital markets, slowing growth, and rising interest rates and expenses. With most of the market now comprised of B-rated credits, these marginal borrowers' ability to service higher debt costs will become an increasingly critical part of the discussion as rates rise.

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As a result, while we're not making significant moves up in quality yet, we're looking more closely at company cash flows, and adding to industries that are less inflation-sensitive, such as gaming and SaaS. We're also adding more short-dated maturities that we think will still be able to refinance in a more challenging market.

EMERGING MARKET DEBT

Emerging Markets (EM) Sovereign Debt: The EM sovereign debt index (JPM EMBI Global) total return of -9.6% was the second worst in the last twenty years – topped only by the COVID-afflicted quarter ending March 31, 2020. The conflict in Ukraine and a hawkish Federal Reserve pivot on inflation concerns caused spreads to widen and Treasury yields to back up significantly, providing a double whammy on bond returns.

The EM index level spread was wider by 53 bps to 379 bps on March 31, 2022, at which time both Russia and Belarus were removed from the index because of heavy sanctions placed on both countries by the U.S., Europe, and the U.K. This resulted in their debt becoming un-investable. The quarter-end index spread level was at 344 bps, so the removal of the securities was equal to approximately 35 bps of spread. At that level, valuations are slightly tighter than the ten-year average spread of 356 bps, while the EM high yield sub-component, at 657 bps, is slightly wide of the long-term average of 641 bps. Meanwhile, the U.S. Treasury curve flattened as rates moved up in an almost unprecedented manner with 2-, 10- and 30-year Treasury yields rising 177 bps, 83 bps, and 55 bps, respectively, over the course of the quarter.

Some performance highlights:

> EM IG returned -11.1%, while high yield, which performed better on a relative basis, still posted a loss of -6.4%. BBBs and longer duration bonds underperformed – the latter due to Russia bonds that started the quarter with an IG rating and finished it at the precipice of default.

> Worst performers included not only Russia, Belarus, and Ukraine, but also Pakistan, due to rising political risk with the possibility of early elections, and Kazakhstan, which has both regional ties to Russia and a major oil pipeline terminating in the Black Sea that suffered operation disruptions.

> Top performing countries included Venezuela on the back of higher oil prices and some signs of possible appeasement from the United States, Lebanon as it moves closer to a possible deal with the IMF, Costa Rica on favorable political developments, and Angola, Iraq, and Ecuador (due to oil).

EM Corporate Debt: The EM corporate index (JPM CEMBI Diversified) return for 1Q22 tracked slightly better than sovereign debt, posting a -8.82% total return. IG bonds underperformed high yield (-9.6% versus -7.9%) and while shorter-end bonds (1- to 5-year notes) fared better than mid- and long-duration bonds. Russia, Ukraine, and Kazakhstan bonds had the worst returns, and like the sovereign index, Russia-related bond issuers were dropped from the index on March 30th.

EM Local Market Debt: Local market index returns (JPM GBI-EM Global Diversified) were also deeply negative at -6.46% on an unhedged basis, but handily outperformed the sovereign and corporate indices. Ex-Russia, which was booted from the index at month-end, the local market index return would have been positive at 1.0% on an unhedged basis. Brazil and South Africa produced robust double-digit gains over the quarter – 18.2% and 11.3%, respectively – while other Latin American countries like Uruguay, Chile, Peru, and, to a lesser extent, Colombia and Mexico, posted healthy single-digit positive returns. Proximity with and ties to the U.S. economy, rising commodity prices, and aggressive central bank hikes were consistent themes among this group, with currency strength against the dollar driving returns rather than rates.

Outlook: Overall, we remain somewhat cautious on EM hard currency debt, with overall spreads at only average levels, and risk of a U.S. recession on the rise. Another concern is a slowing China, with growth there being hampered by an ongoing wave of COVID cases and the government's zero-tolerance approach to the disease. In addition, property sector woes and rising defaults are having a negative impact on confidence and growth.

Finally, the Russia/Ukraine conflict brings two aspects of increased risk, in our view. First, it has substantially increased geopolitical risk premiums in that part of the world. We do not see a quick resolution, but rather a conflict at a slow simmer that will continue to put NATO and Russia at loggerheads with all the attendant risks that come with nuclear powers bumping heads. It will remain an overhang for the foreseeable future.

Second, the inflationary pressure on various commodities including oil, gas, wheat, corn, sunflower oil, and fertilizers, may be here for a while and has negative credit implications across many EM countries where food and energy make up a much larger portion of the inflation basket of goods, and there is much less capacity to absorb higher costs.

SECURITIZED PRODUCTS

The massive move in U.S. Treasury rates driven primarily by inflation fears caused securitized products to produce negative returns. The 2-year U.S. Treasury note backed up by 160 bps to yield 2.34%, and the 10-year Treasury note moved higher by 83 bps to yield 2.34%. During the quarter, the yield curve continued to flatten. As of this writing, it has inverted between the 2-year and 10-year part of the curve.

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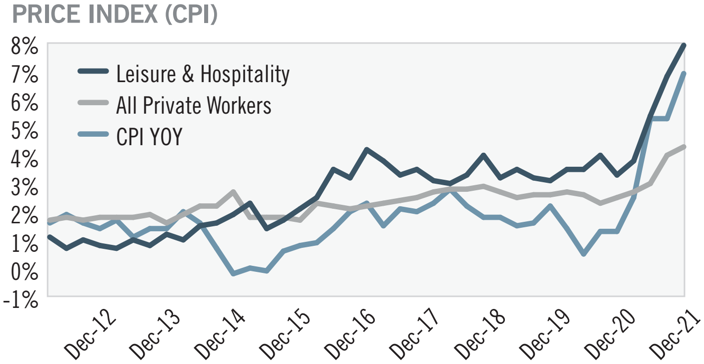
Securitized credit spreads for the quarter were stable for the first two months of the year, but the accelerated backup in the Treasury curve that began during the second week of March caused uncertainty in the markets, which translated into wider spreads for securitized products. For a brief two-week window in March, the securitized market turned from a seller's market into a buyer's market. We used this opportunity to take advantage of yields and spread levels that our market has not seen in quite a while.

We ended the quarter with spreads for credit product narrowing as the rates market settled in and the insatiable appetite for new issue spread product returned. The securitized components of the Bloomberg Aggregate index returned -2.88% for ABS, -5.59% for commercial mortgage-backed securities (CMBS), and -4.97% for mortgage-backed securities (MBS). In general, longer duration credit sensitive product underperformed higher quality shorter duration product.

With respect to new issuance, ABS is running approximately 10% ahead of last year's levels after the first quarter. Private label CMBS new issuance is running close to 100% ahead of last year's issuance. Like the ABS market, the RMBS new issue market is running slightly ahead of last year's pace. From a buyside perspective, other than the sharp rate move during the middle two weeks in March where buyers were hesitant to put dollars to work, the securitized sectors have seen steady demand for paper.

The fundamental picture for the U.S. consumer remained strong during the first quarter as the unemployment rate continued to trend lower, falling from 4.2% at the end of Q4 2021 to 3.6% at the end of Q1 2022. Strong wage gains – especially for the two lower income quintiles – is a positive for consumer credit and housing (see graph below). However, consumer confidence and sentiment trended lower, driven both by inflation concerns and uncertainty over the Russia/Ukraine conflict. Delinquencies for consumer assets trended higher over the quarter, but this signal for future consumer losses hit historic lows in 2021.

EMPLOYMENT COST INDEXES (ECI) AND U.S. CONSUMER PRICE INDEX (CPI)



As of December 31, 2021. Source: Bloomberg LP.

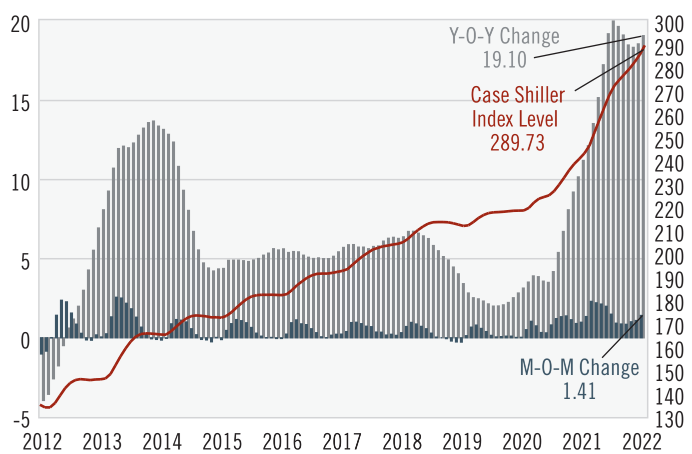
Like most securitized asset classes, investment grade CMBS spreads versus U.S. Treasuries widened, now standing outside of their three-year averages. However, the commercial mortgage market fundamentals continued to improve, with multifamily and industrial properties leading the way. Per Reis data, effective rent growth for both asset types were up a high single-digit percentage on a year-over-year basis, while vacancy rates trended lower.

With respect to retail properties, effective rent growth turned positive for the first time since the pre-pandemic era. According to Smith Travel research, several hotel metrics for U.S. properties, such as the average daily room rate and revenue per available room, have exceeded pre-pandemic levels. Office is the only asset class within commercial real estate that continues to see negative effective rent growth. While office properties continue to demonstrate stability due to long-term leases already in place, the verdict is still out on their medium-term performance as underlying tenant leases begin to roll, especially in high-cost markets.

According to the Real Capital Analytics (RCA) National Property index, which measures appreciation or depreciation based on repeat sales, the commercial real estate market has appreciated 19.40% on a year-over-year basis through February 2022, led by strong performance in multifamily and industrials. Major city office properties have lagged as RCA reports asset appreciation up 5.1% on a year-over-year basis.

The housing market continues to reach new highs, with the latest report showing 19% year-over-year gain for January 2022. Increasing homeowner equity continues to boost the non-agency residential mortgage-backed securities market. The strength of the housing market has been unprecedented. We will be watching closely to see how the residential market performs during the next few quarters as mortgage rates reset sharply higher and affordability issues arise. Below are charts showing increasing home values and mortgage rates.

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



Data through January 31, 2022. Source: Bloomberg Finance LP.

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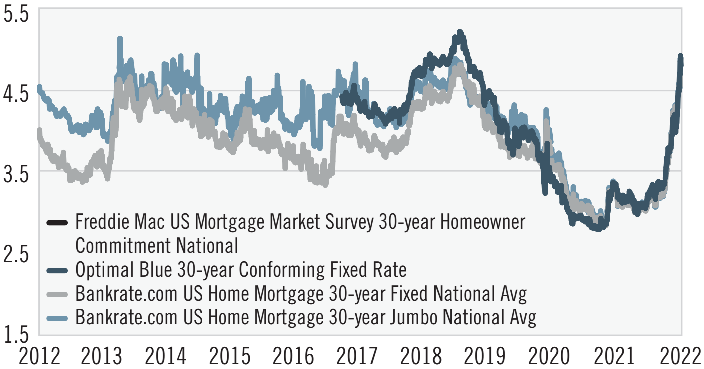
30-YEAR MORTGAGE RATES



As of March 31, 2022. Source: Bloomberg.

Securitized market spreads stabilized at the end of the quarter. Given the partial retracement of spread widening in IG and high yield markets, we feel there are select opportunities available within securitized markets. Our efforts are focused on the new issue markets, which continue to experience strong demand across all securitized sectors. We have focused new dollar investments on the more conservative parts of the capital structure and aim to be selective when taking on credit risk. We continue to monitor and adjust the portfolio based on ever-changing economic news. More importantly, we are positioned to take advantage of any future credit dislocations.

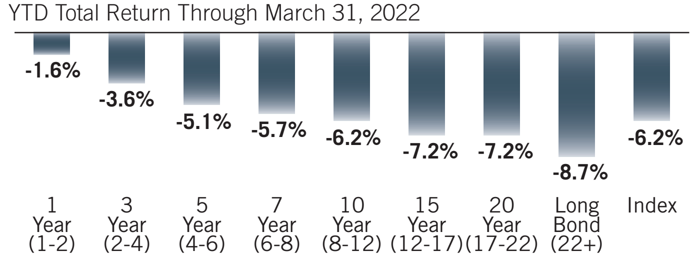
TAX-EXEMPT MUNICIPAL BONDS

Yields in the bond market rose sharply due to the Fed's hawkish stance and the war in Ukraine. Municipal bonds saw the worst quarterly performance in over 40 years, with the Bloomberg Municipal Bond Index returning -6.23%. These yield moves were magnified as municipal bond mutual funds experienced outflows.

During this period, our higher-quality portfolio positioning outperformed, since longer maturing and lower rated bonds were the worst performers in the market. Investors lost interest in taking on additional interest rate and credit risk, even though municipal fundamentals are still on solid footing. This negative performance was the result of rate moves, not due to credit concerns.

PERFORMANCE BY MATURITY

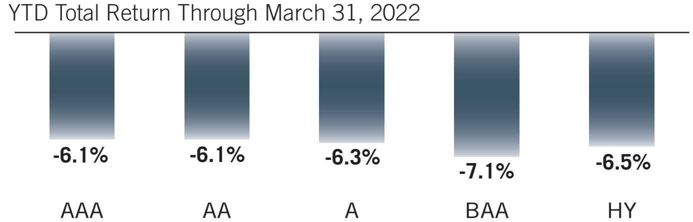
Bloomberg Municipal Bond Index
YTD Total Return Through March 31, 2022



Source: Bloomberg Indexes. **Past performance is no guarantee of future results.**

PERFORMANCE BY QUALITY

Bloomberg Municipal Bond Index
YTD Total Return Through March 31, 2022

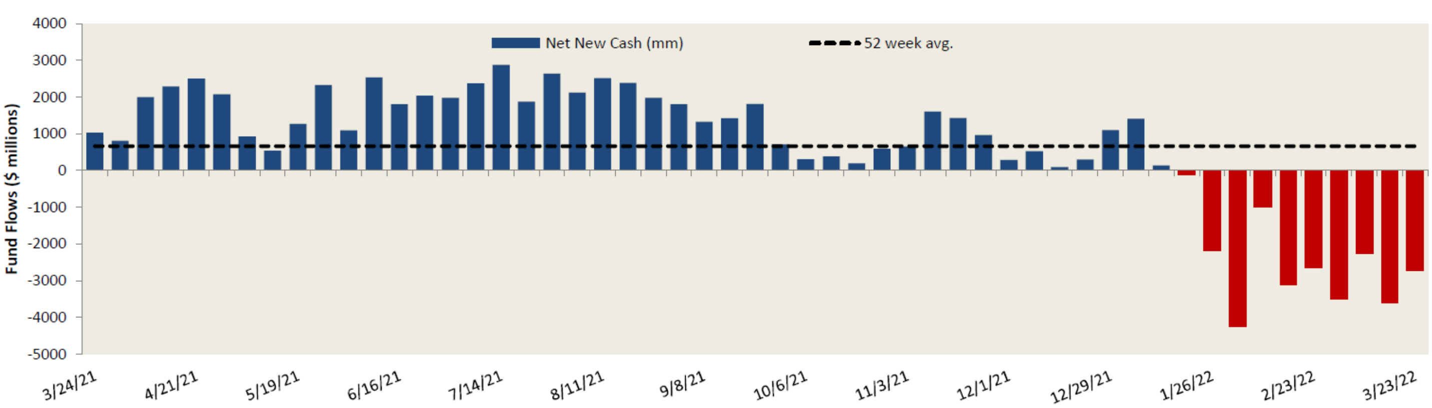


Source: Bloomberg Indexes. **Past performance is no guarantee of future results.**

After 86 consecutive weeks of inflows, the market has now seen 12 consecutive weeks of outflows totaling almost $22 billion. This reversal resulted in selling pressure, causing the market to soften and yields to rise. This trend, which could continue if investors fear that rates will rise further, has the potential to become more problematic for the market.

The good news is that the relative cheapening of municipals has created opportunity for non-traditional buyers, such as banks and insurance companies, who have begun to look opportunistically at municipal bonds as an alternative to other fixed income sectors due to more attractive taxable-equivalent yields. This new demand should lend support to the market.

MUNICIPAL BOND WEEKLY FUND FLOWS



Source: ICI, Baird. As of March 23, 2022.

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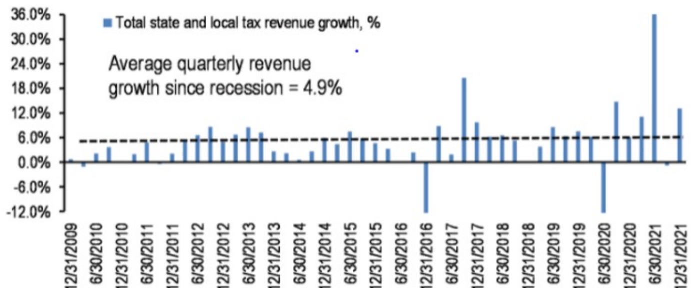
While demand has fallen, overall municipal issuance (shown below) falls short of last year's levels – largely the result of a sharp drop in taxable municipal issuance as market volatility hampered issuers' ability to time refunding deals. On the other hand, supply for tax-exempts has remained relatively flat from levels at the start of last year. The market is expecting supply to accelerate, but rate volatility and geopolitical risk may change that sentiment. For now, supply does not seem to boost or drag down the market.

Municipal credit fundamentals remain mostly on solid footing – especially coming off the pandemic-driven federal stimulus. According to the U.S. Census Bureau, state and local collection receipts for income, sales, and property taxes showed growth of 13.1% for 4Q 2021 from 4Q 2020.

TOTAL STATE AND LOCAL TAX YOY REVENUE GROWTH, %.



Source: U.S. Census Bureau, J.P. Morgan. As of December 23, 2021, seasonally adjusted results.

Rising inflation, initially driven by pandemic-related imbalances, has been exacerbated by the conflict in Eastern Europe and is unlikely to subside easily. Given historical trends, we expect inflation to drive even higher tax collections as costs increase.

While there may be early indications of an impending economic downturn, municipal credit has typically fared better in a recession than other investments, since there is a lag between a recession's onset and when municipalities begin to see their finances challenged. That is especially relevant for local municipalities that rely on property tax revenues – the sizeable increases in nationwide housing values should provide stronger revenue.

Following an unprecedented quarter of negative returns, municipal bonds are showing better relative value than they have in a long time, with yield moves not seen since 2008. Fortunately, these moves weren't driven by credit issues as they were back then, but were rather a result of fund outflows, higher Treasury yields, and a catch-up from overinflated valuations. In times of heavy fund outflows, demand from non-traditional buyers can provide much-needed support.

We expect that the current volatility will continue until the market gains clarity on the Fed's intentions and Treasury rates begin to stabilize. Should the economy start to slip into a downturn, it is important to remember that municipals have long been considered a high-quality investment, with defaults a rarity.

For more detail on tax-exempt municipal bonds in the fourth quarter, see Newfleet's 1Q22 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.