NEWFLEET ASSET MANAGEMENT

Fixed Income Sector Review

As of June 30, 2022

OBSERVATIONS ON THE MACRO ENVIRONMENT & MARKET CONDITIONS

- Central banks to continue to tighten despite slower growth.
- The Fed & European Central Bank (ECB) have turned more hawkish. They realize they are behind the curve in fighting inflation and are now more willing to sacrifice some growth to contain it before the cost becomes too high.
- Market confirmation of this reflected in:
    - Recent Treasury rally.
    - Second yield curve inversion of 2022.
- Consensus forecasts of policy rates (determined by the Fed & ECB) higher than Treasury yields (determined more by markets).
- Commodities that have been rallying up until now are rolling over. The pace of US$ strength has also accelerated.
- The key to whether we should increase our level of risk centers on whether enough risk premiums in all financial asset prices have been restored to prevent credit spreads on risky bonds from widening more.
- Risks to our view include:
    - The Fed & ECB do not overtighten, and a soft landing ensues.
    - The Fed & ECB overtighten, only for inflation to remain elevated. Tighter monetary policy may reduce inflation expectations, but it is unlikely to lower aggregate demand enough to offset the impact on current actual prices emanating from reduced commodity supply & disrupted supply chains.
    - Housing and private equity markets finally take a hit.
    - Further pressure on crypto currencies. There is significant hedge fund involvement, and many have a lot of leverage.
    - Japanese yen weakness persists and/or the Bank of Japan abandons yield curve control. This, in turn, reduces the availability and/or raises the cost of one of the major sources of carry trade and, maybe, crypto funding.
    - China grows > 4.5%.
    - The Russia/Ukraine war is quickly resolved.
    - Peripheral EU bonds de-anchor from bunds.

SECTOR ASSESSMENTS

Positive / Constructive / Neutral / Cautious / Negative

	Credit			Securitized Product				Non-U.S.			Municipals	
	IG CORP	HY CORP	BANK LOANS	ABS	MBS	RMBS	CMBS	EM HY	YANKEE GOV	NON-USD	TAX-EX	TAXABLE
Fundamentals	Constructive	Neutral	Cautious	Constructive	Neutral	Neutral	Neutral	Cautious	Cautious	Cautious	Positive	Positive
Technical	Negative	Cautious	Neutral	Neutral	Cautious	Neutral	Neutral	Cautious	Cautious	Cautious	Negative	Positive
Valuations	Constructive	Neutral	Neutral	Constructive	Cautious	Constructive	Neutral	Constructive	Neutral	Neutral	Constructive	Neutral

Newfleet's assessments of non-government spread sectors as of June 30, 2022. 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.

SELECT SECTOR HIGHLIGHTS

Investment Grade Corporate Bonds

- Trailing 12-months returns through the end of June were -14.2%. This is about as bad as we have ever experienced in the asset class. It could certainly get worse, with spreads now well wide of averages at 156 bps (basis points), but inside of recessionary levels. Rates would typically provide an offset from a total return standpoint, but inflation needs to cooperate for that to happen.
- Earnings estimates for 2022 call for 4.1% growth in the second quarter, with a ramp to 10% earnings growth in the back half of the year. Whether anyone still believes in these forecasts is another question altogether, and we suspect the answer is “no.” We are expecting sharper than normal revisions to back half earnings.
- Spreads ended the month at 156 bps, a two-year high, and equivalent to the highs reached in the late 2018 growth scare. Yields hit 5% during the month and ended at 4.7%. The last time yields were this high was coming out of the Great Financial Crisis in 2009.

High Yield Corporate Bonds

- In June, the high yield index spread widened at a pace not seen since the Great Financial Crisis in 2008, creating total return of -6.73%. While the weakness was mostly evenly distributed, Bs generated the worst return of -7.11%.
- Aggregate margins have started to decline as companies struggle to increase prices to fully offset raw material costs, continued supply chain disruptions, and rising labor costs.
- Despite the move wider, we viewed spreads as still low relative to recessionary levels, which seem increasingly likely. We continued to high grade the portfolio by rotating out of more cyclical credits and into higher-quality, more recession-resistant securities and holding an elevated level of cash. We will re-evaluate the strategy should valuations continue to cheapen and/or the FOMC’s posture changes.

Bank Loans

- Current valuations are introducing some total return, recognizing that markets are still re-pricing credit now. This, coupled with a rising base rate (and commensurate coupons) may provide a dollar cost average entry point for long-term investors.
- CLO issuance remained surprisingly resilient even as AAA liabilities continue to widen, and managers and investors are finding creative ways to structure portfolios and come to market. This acts as a good barometer of where demand lies. Still, a less than attractive arbitrage as we enter the slower summer months could be a demand headwind.
- Our focus remains on de-risking the portfolio by re-allocating to higher-quality credit, adding to seasoned issuers we have historically monitored, and industries that are less sensitive to the current inflationary environment.

Securitized Product

- In general, shorter duration higher-quality assets outperformed longer duration lower-quality assets for the month. We are currently booking yields in the 4.50% to 5.50% range for short-average-life investment grade assets.
- With yields higher and spreads wider, we see a lot of value in the consumer space, which we are adding prudently to the portfolios. We continue to favor up in quality consumer and residential exposures as deal cash flows shrink with higher financing and liquidity costs.
- CMBS fundamentals are holding up, but we expect maturity extensions due to rising borrowing costs.

Emerging Market Debt

- Emerging markets debt (EMD) dropped by 5.54% in June, bringing the year-to-date total return to -18.83% − by far the worst performing sector in the bond market. EMD’s YTD drawdown was 848 bps worse than that of the Bloomberg U.S. Aggregate Bond Index (US Agg), which dropped by 10.35% YTD. Even excluding the impact of Russia, which accounted for about 300 bps of the YTD decline, EM debt still underperformed by a lot.

Continued

- One of the risk factors is that both the Fed and ECB may overtighten to set policy rates closer to inflation. We doubt G7 real policy rates will be ratcheted up to positive territory, as the current growth trends could not handle it due to the risk of recession. However, we do believe policy rates should at least be less negative, and we expect this to be the outcome for this cycle.
- While risk premiums have risen meaningfully, credit risk spreads are still not wide enough to induce us to buy aggressively.

Municipal Bonds

- Total returns were weakest in long duration and lower-rated securities as yields rose across the curve and spreads widened.
- Yields moved in a bear steepener. The slope of the curve (30-year yield – 2-year yield) increased from 77 bps to 123 bps. The 2-year yield increased by 19 bps, and the 30-year yield increased by 65 bps. BBB yields increased by 93 bps compared to AAA, which only increased by 50 bps.
- Municipal mutual funds saw outflows of $60 billion for the quarter, bringing the year-to-date total to $88 billion.
- Issuance was lower in the second quarter compared to 2Q21 by 13%.

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