Q3 22 MULTI-SECTOR FIXED INCOME
MARKET REVIEW AND OUTLOOK

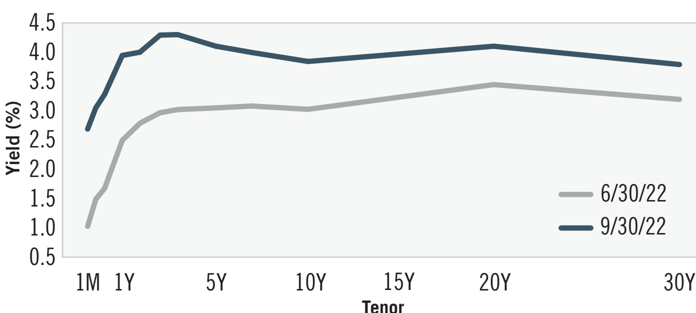
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Global central banks continued to fight inflation during the quarter with a series of unusually large policy rate increases. Their messaging has been consistent: they will stay focused on returning high inflation levels to target. The backdrop clouded the outlook for global and regional economies, with the probability of recession rising. This has resulted in negative total returns for most assets. The pandemic is still a global issue, with China's zero-COVID policy continuing to delay the normalization of supply chains, though the rigid policy may be eased in the coming months. Meanwhile, the war between Russia and Ukraine is an ongoing economic shock to food and energy prices. These unresolved issues make economic forecasting and modeling a challenge and will likely contribute to a volatile investing environment for the next several quarters.

The Fed raised its main policy rate 150 basis points (bps) during the quarter in two jumbo moves of 75 bps each and signaled its resolve to restore price stability. The Fed is also set to increase the pace of its $8.9 trillion balance sheet run-off in September. While we still expect this to be a largely passive exercise, the market is watching for signs that the Fed may be open to selling off its mortgage-backed securities (MBS) when caps are not met. The European Central Bank (ECB) also joined the inflation fight and raised its policy rate to 125 bps over two meetings, marking the first increases off zero since 2016. In addition to managing the start of its own balance sheet run-off, the ECB will have to manage the complex task of preventing financial fragmentation among its member countries. The Bank of Japan is still a relative dove given local economic conditions, but it remains to be seen how much yen weakness will be tolerated, given the policy divergences. Global central banks have a complicated task ahead, but we are confident in their ability to contain inflation.

Financial markets have priced in significant changes to the economic and earnings landscape during the quarter, as shown by total returns. The U.S. Treasury curve shifted higher:

U.S. TREASURY YIELD CURVE



Source: Bloomberg L.P. As of September 30, 2022.

the 5-year Treasury yield jumped up 105 bps, the 10-year Treasury yield went up by 82 bps, and the 30-year Treasury yield moved 59 bps higher. Most spread sectors underperformed U.S. Treasuries with the shifting economic conditions.

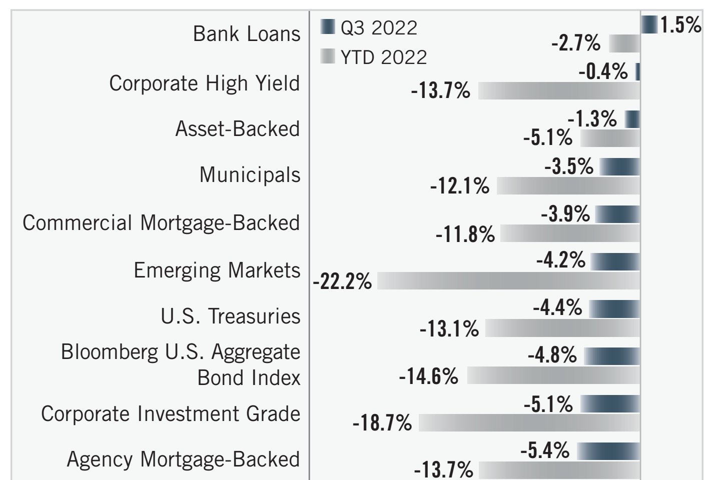
Despite the quarter's volatility, we see value being restored across most of the fixed income sectors in which we invest. It is our expectation that supply chains will heal over time and the Fed will be successful in returning inflation to acceptable levels. We continue to watch the economic data to inform our views on the possibility of recession. While our base case remains that any contraction would be mild, recession risks have risen.

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 have implemented for over 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

Most spread sectors underperformed U.S. Treasuries with the shift in economic conditions.

FIXED INCOME SECTOR PERFORMANCE



Performance as of September 30, 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.

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

INVESTMENT GRADE

Investment grade yields ended the quarter at a 10-year high, with dollar prices at a 10-year low. Returns of -18.5% for the last twelve months are the worst on record, eclipsing the

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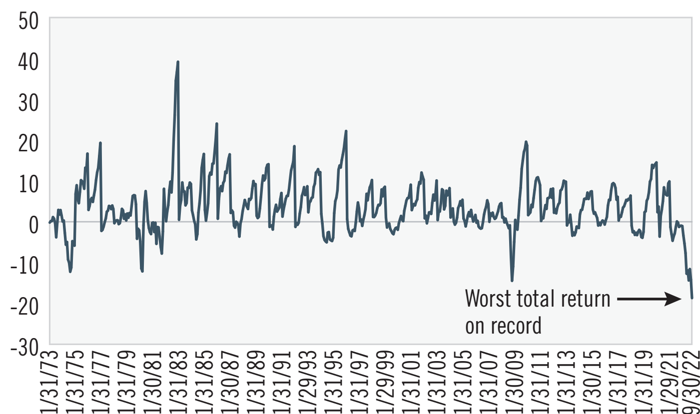
1980 low of -15.8%. Spreads are roughly midway between average and recessionary, ending the quarter at 158 bps. While spreads typically go wider during recessions – and a recession seems increasingly likely – the combination of yield, spread, price, and fundamentals suggests that the risk/reward for the asset class tilts in the investor's favor.

INVESTMENT GRADE TOTAL RETURNS – 1973-PRESENT



Date through September 30, 2022. Source: Bloomberg LP.

Credit metrics have improved to pre-COVID levels. Interest coverage is likely to rise despite rising rates as the average maturity is north of 10 years, so the maturing coupons are comparable to new issue coupons. EBITDA is growing and inflation can be a tailwind to that figure. We saw aggressive share repurchase activity in the second quarter that cut into high cash balances, though this was most pronounced for the higher ratings tiers. Downgrade waves are typically driven by a troubled industry – this has yet to be identified in this cycle.

Technicals remain challenging. Outflows accelerated to close out the third quarter. In the context of the worst total return environment on record, outflows have been tame, but they have been consistent all year. Foreign buyers make up a significant portion of the market, but rising hedging costs are making that trade less economic and blunting the demand there. Supply stands out relative to other sectors with YTD supply down by just ~10%. By comparison, supply for high yield and leveraged loans is down more than 75%. This relatively heavy supply in a market with limited appetite is resulting in historically high new issue concessions. Taking advantage of these has been our preferred way to participate in the asset class.

CORPORATE HIGH YIELD

The high yield index lost just 0.64% during the third quarter, but this near-zero return masks large underlying volatility – the index was up 7.75% through mid-August. Credit spreads entered the quarter at +570 and tightened to +409 in early August before widening to +554 at quarter-end. Risk-free rates were also volatile, with the 5-year Treasury rate rising 1%. Volatility remains driven by the market's view on whether the Federal Reserve can engineer a soft landing in its quest to push inflation lower. Recent comments suggest a hawkish bent by the Fed, with more tightening into year-end and early 2023. Year-to-date returns on the index are down over 14%, with the yield hitting new highs at 9.7%. BB-rated bonds saw the worst total returns because they have the highest duration within high yield. Excluding rate impacts, CCC-rated securities underperformed – they were the only rating tier to see credit spreads widen during the quarter.

Aggregate credit fundamentals remain relatively strong ahead of a potential slowdown. Aggregate leverage is at its lowest level since the fourth quarter of 2019, and meaningfully below recent peaks. The aggregate interest coverage ratio is still extremely high, but aggregate statistics mask some pressure in CCC-rated issuers, especially those who have floating rate debt in their capital structures. Overall, while fundamentals are likely to deteriorate over the next several quarters, there is room for weakening before they reach levels that are problematic for the whole sector.

The technical picture is mixed. Despite significant outflows year-to-date, supply and demand dynamics are more balanced due to a negative net issuance forecast driven by low gross issuance and a sizable number of rising stars (bonds moving from high yield to investment grade). The heavy issuance of the last two years has left little debt to refinance; meanwhile, the move wider in rates and spreads have sharply reduced the number of bonds with economic calls. Most deals coming to the market are funding M&A activity in which the issuer has little choice but to tap the market. These have been met with poor reception due to their aggressive structures and the overall economic uncertainty. As a result, we have seen deals pulled and delayed until conditions improve, which is a bit concerning as one could argue the new issue market is closed for CCC-rated bonds.

We remain cautious on the asset class because spreads are still inside of recessionary levels, even when adjusting for the higher quality of the current index versus historical averages, and because recession risks remain elevated given aggressive Fed tightening. Activity during the quarter was more muted than usual as volatility led to wider bid-ask spreads. Trades generally focused on high-grading the portfolio via purchases of BB-rated securities.

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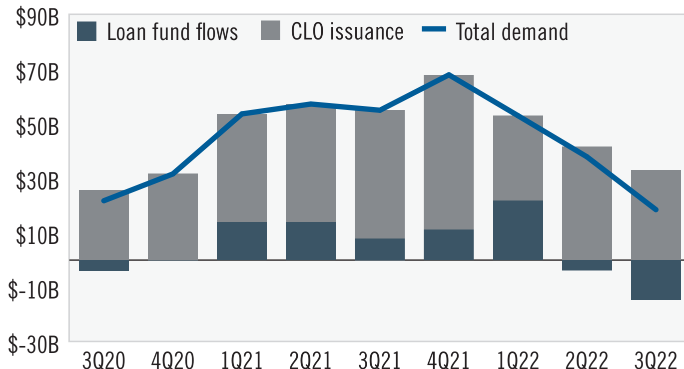
BANK LOANS

Though overall loan performance for the third quarter was positive at 1.19%, headlines drove risk-on and risk-off swings throughout the period. An encouraging CPI print in July that seemed to show inflation cooling, or at least peaking, raised hopes that the Fed might soon pivot and slow the pace of its aggressive rate hikes. This contributed to risk-on sentiment and positive performance that continued through August until the Fed's Jackson Hole meeting.

At Jackson Hole, the Fed dashed market hopes for a pivot on rates, sending a firm message that bringing prices under control was still its main priority. Meanwhile, disappointingly elevated data prints in September continued to soften overall outlook, with markets increasingly gearing up for a potential recession. The Fed's rate hike of 75 bps on September 21st also dealt a blow to the market – loan performance was down 2.27% for the month, with the last week of the month accounting for 1.5% of that figure.

On the technical side, the loan market continued to see outflows as retail investors turned their focus to credit risk over rising rates. Demand in the CLO market also started to soften due to underlying credit concerns, relative value to other structured products, and as traditional large buyers such as banks remained largely absent.

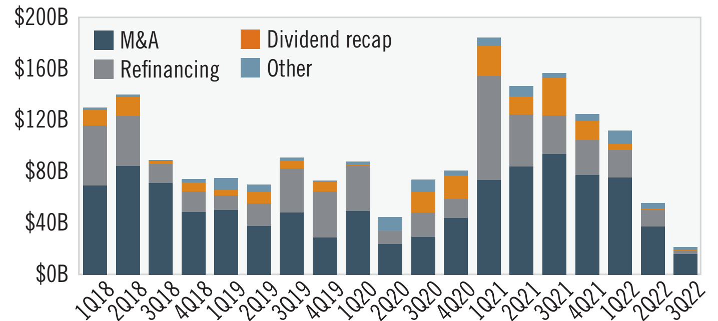
U.S. LEVERAGED LOAN MARKET MEASURABLE INVESTOR DEMAND



Data through September 30, 2022. Fund flows data includes monthly reporters.
Sources: Leveraged Commentary & Data (LCD); Lipper.

There was one silver lining: these outflows were more than offset by anemic supply. Issuance for the quarter plunged to the lowest amount since the fourth quarter of 2014 as volatility hindered M&A and LBO deal flow. Citrix, a closely watched bellwether expected to set the tone for the primary market, was poorly received, trading below its offering price and leaving banks holding portions of the loan. This repriced the secondary and primary markets and also put the next set of deals that needed to come to market on hold.

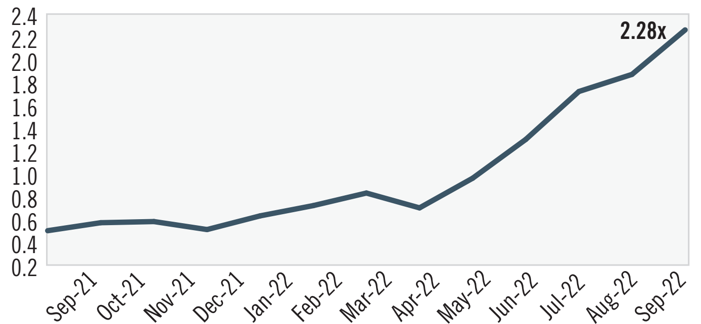
U.S. INSTITUTIONAL LOAN VOLUME



Data through September 30, 2022.
Source: Leveraged Commentary & Data (LCD).

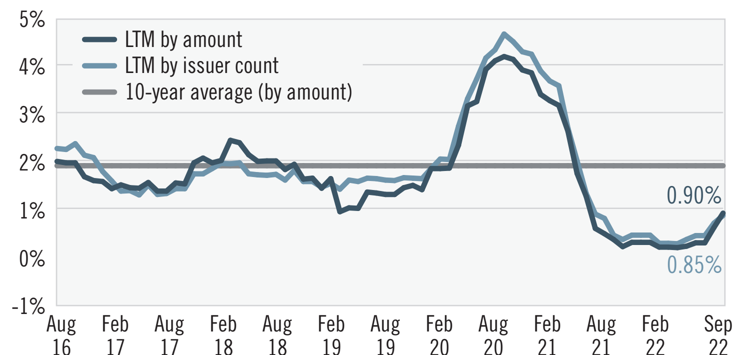
Meanwhile, loan market fundamentals are starting to trend in the wrong direction, with downgrades outpacing upgrades for a fourth consecutive month on a three-month rolling basis. The downgrade count of loan facilities in the Morningstar LSTA US Leveraged Loan Index exceeded upgrades by 2.28x in September, up from 1.32x in June. The lagging twelve-month default rate by principal amount also ticked up to 0.90% up from a low of 0.26% in April. That said, the 10-year historical average default rate is 1.89%.

U.S. LEVERAGED LOANS: RATIO OF DOWNGRADES TO UPGRADES



Data is rolling 3 months; through September 30, 2022.
Sources: Leveraged Commentary & Data (LCD).

U.S. LEVERAGED LOAN DEFAULT RATE



Data through September 30, 2022.
Sources: Leveraged Commentary & Data (LCD), Morningstar LSTA US Leveraged Loan Index.

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Given that fundamentals already seem to have peaked, this quarter reflects a broader up-in-quality theme for the year. Starting from the assumption that rate increases would affect future growth, we have been moving up in quality by increasing our cash position, increasing exposure to BB credits, and cutting CCC-rated exposure in half. Our underwriting also led us to screen out companies with low interest coverage ratios, sectors that were particularly susceptible to inflation, and aggressive post-COVID deals from 2021. This, along with our underweights to the healthcare and tech sectors, helped performance.

Looking ahead, we think it is too early to add back risk, as we do not yet think lower-rated credits offer adequate compensation. As of the end of the quarter, discount margins for BB-rated credits hit levels comparable to B-rated credits back in April – meaning there is no reason to go lower in quality when higher quality prices today equal where lower quality was priced back in April. Given all this, we expect our positioning for the fourth quarter will remain largely unchanged, though we will keep watching the market for dislocations and opportunities as they arise.

EMERGING MARKETS DEBT

EM Sovereign Debt: Emerging (EM) sovereign debt index (JPM EMBI Global) total return was negative again for the third consecutive quarter, posting a return of -4.2%. Monthly returns were volatile during the period, with July returning +3.2% as EM assets rallied after a substantial drawdown that ended mid-July. August returns then fell -1.16% and continued falling in September, which registered a -6.1% return – the worst monthly return in a year that has seen some pretty bad months. The negative quarter brought the full year-to-date return down to -23.4%, which would exceed the worst year ever for EM debt.

Some performance highlights from the quarter:

> With two Fed rate hikes totaling 150 bps during the quarter, there was a massive U.S. Treasury curve inversion and overall sharp rise in Treasury rates. This was the main driver of overall negative EM returns.

> Though EM index spreads only moved 8 bps wider for the quarter, they saw a fair amount of volatility during the period – first rallying sharply from 458 bps at the beginning of the quarter to 401 bps on September 12 before widening out to end the quarter at 466 bps on the back of negative revisions to the global growth and inflation outlook in mid-September.

> EM high yield bonds outperformed EM investment grade bonds by 151 bps on a total return basis (-3.29% vs -4.8%) in the quarter. CCC-rated debt, which makes up less than 4% of the overall index, registered the worst performance with a -9.3% total return.

> With the move wider in rates, longer-duration bonds were predictably the worst-performing segment of the market, with the 10+ year portion of the index returning -6.6%.

> Among countries, the worst performers included Pakistan (-36.5%), which was hurt by rising default risk as reserves dwindle, fiscal and current account balances remain under pressure amid higher food and energy prices, and the country grapples with the fallout from its recent floods; Ecuador (-30%), which saw increased political risk and lower oil prices; and Ukraine (-28%), whose bond valuations fell to the low 20s as a 24-month debt moratorium agreement was reached with bondholders during the quarter, and as estimates to repair war-related damages now run close to $400 billion. Other double-digit negative returns included distressed names like Argentina (-12%), Ghana (-20%), Sri Lanka (-16%), and Zambia (-20%).

> Top performers included El Salvador (+18%) after it announced an above market, but below par, partial debt tender, along with Turkey (+3%), Honduras (+8.1%), Kenya (+2.3%) and Brazil (+0.47%). A handful of other smaller issuers like Jordan, Georgia and Ivory Coast also registered positive returns

EM Corporate Debt: Corporate debt fared better, but still registered a negative return of -2.66% on the EM corporate index (JPM CEMBI Diversified). As with sovereign bonds, high yield outperformed (-1.58%), while long duration bonds lagged (-4.98%).

EM Local Debt: Local market index returns (JPM GBI-EM Global Diversified) were -4.2% for the quarter on an unhedged basis, roughly in line with the sovereign bond index. Turkey local bonds returned 20% in the period after the central bank cut rates and announced a regulatory measure that will force local banks to purchase more government debt going forward. Brazil local bonds posted a +1.75% return in the period. Meanwhile, Hungary, Colombia, and Philippines were double-digit negative return losers in the quarter.

Our outlook remains cautious. The probability of recession in Europe and the United States has increased in recent weeks. In addition, China's economic growth continues to sputter due to its zero-COVID policy and a depressed property sector. Its 2022 growth forecast in the low 3% range will be the lowest GDP growth level since the late 1970s, excluding 2020. EM high yield spreads greater than 900 bps are well wide of historical levels, but the economic and funding challenges facing lower-rated countries are daunting. Defaults and debt restructuring are likely to increase over the next 12 months, and while there may be some opportunities, credit selection will be at a premium.

continued

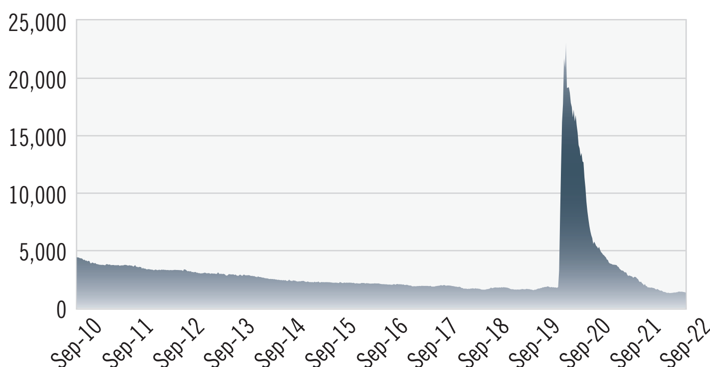
SECURITIZED PRODUCT

A Federal Reserve determined to bring down inflation drove the front end of the yield curve to levels that have not been seen since 2007. Like most risk assets, securitized product spreads widened across all rating categories, though longer-duration, credit-sensitive products generally underperformed higher-quality, shorter-duration credits. The securitized components of the Bloomberg Aggregate Index returned -1.34% for ABS, -3.85% for CMBS, and -5.34% for MBS.

On the technical side, we saw a noticeable slowdown in issuance. Given the dramatic interest rate back-up we experienced, we expect new issue supply to be muted in the fourth quarter and yearly issuance to trail 2021 issuance. Though the new issue market is open as of this writing, prime and non-prime credits have become bifurcated – a result of the uncertain economic environment. Prime assets are met with strong demand in the primary and the secondary market, while non-prime assets see less demand due to recession fears. Consequently, non-prime issuers are having a harder time finding the correct clearing level when new issue deals are in the primary market.

Thus far, the U.S. consumer's fundamentals have stayed positive thanks to the low unemployment rate, strong wage gains, a strong excess savings profile, and an abundance of job openings. Consumer confidence and consumer sentiment both rose at the last reading, driven by lower energy prices. In addition, U.S. continuing jobless claims sit near all-time low levels. We also continue to see low delinquencies from prime borrowers across consumer assets. Non-prime delinquencies in both the auto and unsecured consumer space are trending higher – albeit off historically low levels. Within the housing market, mortgage delinquencies remain at benign levels.

U.S. CONTINUING JOBLESS CLAIMS



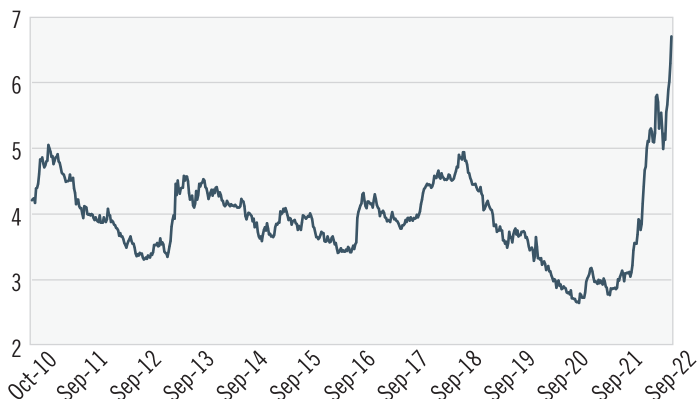
Data through September 16, 2022. Source: Bloomberg LP.

That said, unemployment is forecast to move higher for the rest of this year and into 2023. This, combined with the likelihood that excess savings will be drawn down due to inflation and higher forecasted energy prices, does not bode well for future U.S. consumer performance.

While delinquencies are also still low in the commercial mortgage market, performance is bifurcated between sub-sectors – industrial and multifamily properties have enjoyed stellar performance, while the office and retail sectors face uncertainty. Retail has been a mixed bag, with strip centers outperforming Class B and C malls by a wide margin. 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. If the work from home trend persists, Class A office properties are better positioned than their B and C counterparts. Looking ahead, higher interest rates will negatively affect commercial real estate valuations as cap rates reset higher.

The housing market is quickly coming off the boil with the increase in mortgage rates filtering through the sector. High levels of homeowner equity and stringent underwriting continue to bolster credit performance within non-agency residential mortgage-backed securities (RMBS). The differing securitization structures within non-agency RMBS provided opportunity compared with agency MBS passthrough securities, which led non-agency securities to outperform during the quarter. The strength of the housing market has been unprecedented, but affordability issues with the dramatic increase in mortgage rates will certainly diminish demand. With employment still robust and mortgage credit benefiting from substantial housing price appreciation, we continue to find attractive opportunities in the RMBS market.

FREDDIE MAC U.S. MORTGAGE MARKET SURVEY – 30-YEAR MORTGAGE RATE



Data through September 29, 2022. Source: Bloomberg LP.

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With the potential for higher delinquencies and losses amid a slowing economy, our investments are focused on the senior tranches of the capital structure. These tranches offer the most protection from an increase in deal loss and can sustain multiples of base case losses. Being well-positioned for higher delinquencies also creates opportunities to purchase cheaper, higher-quality assets in the future.

Wider yields of 6%-7% for high quality assets and yields greater than 8% for investments further out on the risk spectrum provide investors with income we have not seen in the bond market since 2007. Uncertainty brings opportunity, and today we continue to focus 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.

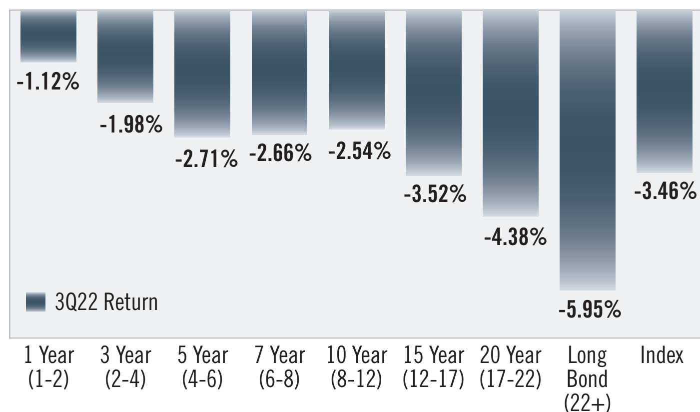
TAX-EXEMPT MUNICIPAL BONDS

Inflation, higher rates, and volatility took their toll during the third quarter in a thinly traded market. The Bloomberg Municipal Bond Index, a broad measure of the municipal market, returned -3.84%, bringing the year-to-date return to -12.13%. Year-to-date, the Bloomberg Municipal Bond Index outperformed the Bloomberg Aggregate Bond Index (-14.61%), Bloomberg Corporate Index (-18.72%) and Bloomberg Treasury Index (-21.27%).

Early in the quarter, demand outstripped supply, though September transitioned the stage to less favorable technicals for October and November. Though municipals continue to loosely follow the volatility of the Treasury market, front-end municipal demand has kept the municipal curve at a positive slope, unlike the Treasury market.

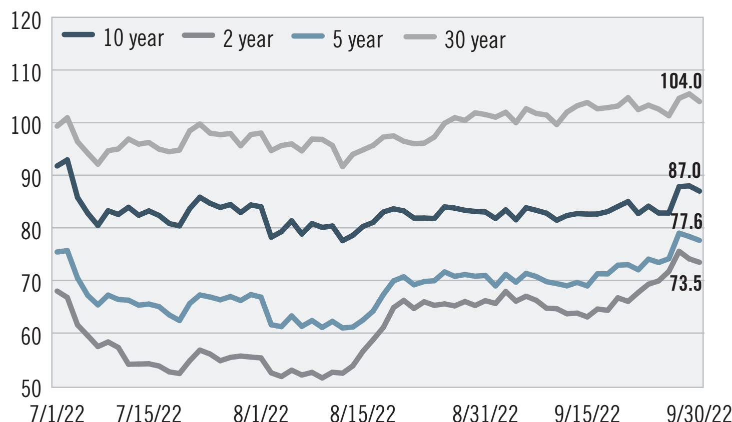
By the end of September, ratios cheapened up quite a bit versus Treasuries, which began to attract buying interest from some insurance companies and crossover buyers.

BLOOMBERG MUNICIPAL BOND INDEX MATURITY DISTRIBUTION



As of September 30, 2022. Source: Bloomberg.

MUNICIPAL BOND/TREASURY RATIOS



As of September 30, 2022. Source: Bloomberg

For the quarter, the declines in quality issues were nearly even. AAA was down 3.50%. AA fell 3.34%, A dropped 3.51%, and Baa was down 4.07%. But quality continues to hold its own better than other ratings, and there is much more liquidity in higher quality.

Momentum turned more favorable at the beginning of October as muni ratios looked attractive, though whether that trend holds is another matter. If retail investors remain skittish, illiquidity could continue, since dealers are reluctant to hold inventory in this sort of market. But that can change quickly – once the market appears poised to rally, there are often not enough bonds to meet demand. Given that the less favorable seasonality we mentioned typically changes mid-November, demand should eclipse supply by the end of November, December, or January, depending on what happens in the Treasury market.

While there has not been as much improvement on the credit side as we saw in the first half, we are not seeing much decline yet, either. Obviously, the overarching concern is whether we go into a recession – and if so, how severe – and the ramifications for states, cities, and revenue bonds. Against that backdrop, we are a little cautious on hospital bonds that have come under pressure. Another yellow flag would be any state or local municipality that did not shore up its finances while the opportunity was good. Meantime, we remain selective about transportation and airport issues and believe there are still some very good credits there.

Regardless of what happens with the Fed, we are more oriented toward bonds that are very well-positioned for a recession: high-quality bonds which are easier to sell, even in illiquid markets, and higher-coupon bonds (5%), which have also held their value better. On the other hand, people who bought 4% or 3% coupons on 20- or 30-year bonds last year, and even earlier this year, are now priced at very deep discounts.

continued

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 U.S. Aggregate Bond Index measures the U.S. investment grade fixed rate bond market. **Bloomberg 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 U.S. High-Yield 2% Issuer Capped Bond Inde**x 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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