1Q 18 | VIRTUS VIEWPOINTS

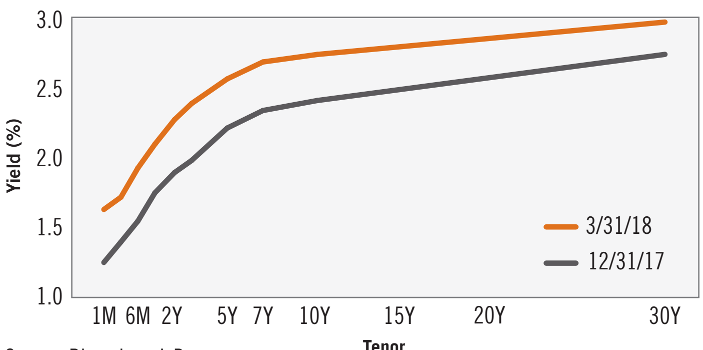
MARKET REVIEW AND OUTLOOK

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

The overall positive tone for fixed income spread sectors was challenged in the first quarter with bouts of elevated volatility. Investors were forced to interpret the potential market implications of the emerging risks of a trade war among major economic powers; the changing composition of the Federal Open Market Committee (FOMC), including a new chair; as well as the ongoing evolution of the quantitative easing (QE) programs initiated by the key global central banks in the aftermath of the financial crisis. During the quarter oil prices moved higher, U.S. economic data modestly improved, and interest rate volatility remained elevated. VIX, an indicator of expected equity market volatility, soared 80% over the first quarter.

As expected, the Federal Reserve (Fed) increased its target rate during the quarter to a range of 1.5%-1.75% at the March FOMC meeting. The European Central Bank and Bank of Japan are expected to continue with QE until late 2018 and early 2019, respectively.

U.S. TREASURY YIELD CURVE



Source: Bloomberg L.P.

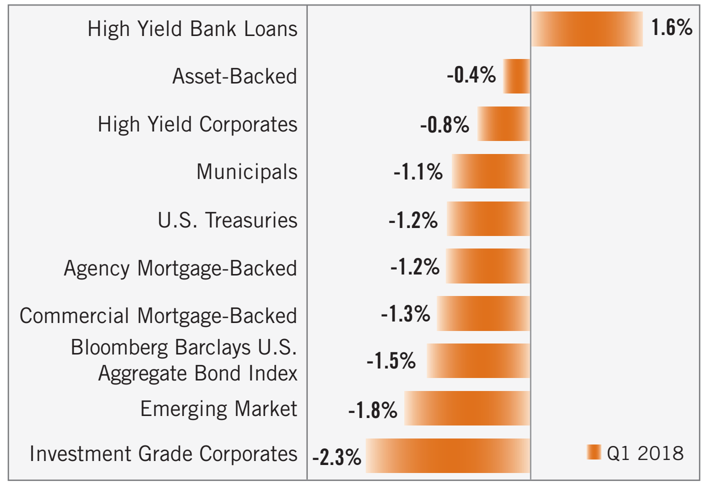
During the quarter yields were higher across the curve, although more pronounced at the front end. Overall, the curve flattened. The yield on the benchmark 10-year U.S. Treasury ended the quarter at 2.74% having started the quarter at 2.41% and touching 2.95% on February 21.

The U.S. economy posted fourth quarter 2017 annualized GDP growth of 2.9% following 3.2% growth in the third quarter. The labor market remained firm (unemployment remained steady at 4.1%) and the housing market was stable. Core PCE (personal consumption expenditures ex food and energy), at 1.6% year-over-year, remains below the Fed's 2% target.

FIXED INCOME SECTOR PERFORMANCE

With the exception of bank loans, spread sectors had negative returns for the quarter with investment grade corporate bonds the biggest underperformer. Long duration assets across sectors underperformed on a total return basis as interest rates rose. After being the best performer in 2017, emerging markets debt was particularly vulnerable to rising U.S. rates and fears of a trade war, despite improving fundamentals.

FIXED INCOME SECTOR PERFORMANCE

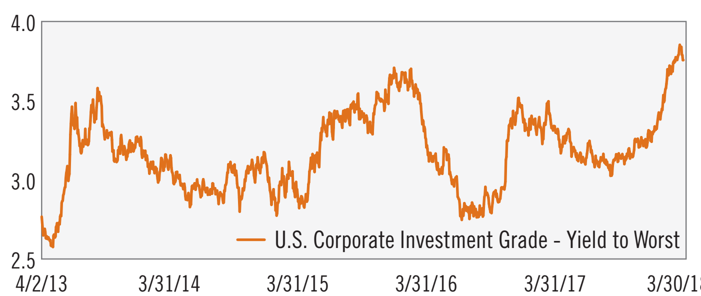


Performance as of March 31, 2018.
Sources: J.P. Morgan: Emerging Markets (EMBI Global), High Yield Corporates, High Yield Bank Loans; Bloomberg Barclays Municipal Bond Index: Municipals; Bloomberg Barclays U.S. Aggregate Bond Index: All other sectors.
Past performance is no guarantee of future results.

INVESTMENT GRADE

Corporate bonds were the weakest performing sector in the first quarter with a total return of -2.32%. The combination of rising interest rates and an index duration of 7.5 years was responsible for most of the damage, but excess returns of -0.79% were the result of a rapid reversal in the technical environment. The option-adjusted spread (OAS) on the Bloomberg Barclays Corporate Bond Index widened 16 bps YTD to 109 bps, but the intra-quarter move was even sharper. On February 2nd, the OAS of the index hit a 10-year low of 85 bps before widening out 24 bps in less than two months, a 30% move. Despite this move, spreads remain 20 bps tight to their three- and five-year averages. The yield of the index is 50 bps higher YTD at 3.76%, 50 bps higher than three- and five-year averages. This yield remains superior to global alternatives, e.g., European corporates (0.90%) and Asia-Pacific corporates (1.13%).

INVESTMENT GRADE CORPORATE YIELDS 2013-2018



Source: Bloomberg L.P.
Past performance is no guarantee of future results.

From February 2016 to February 2018, IG corporates enjoyed a smooth glide from spreads of +215 bps to +85 bps. This was driven by a highly supportive technical environment. Foreign investors, mutual funds, corporations, and others were all adding to the asset class simultaneously. In February, we saw demand disappear while supply ramped higher. Foreign investors faced rising hedging costs and contemplated the impact of an unwinding of global quantitative easing programs. Mutual fund investors were discouraged by a rising rate environment and negative total returns. Corporate buyers, who were deploying "cash held overseas" in short duration IG corporates, could now repatriate this "cash" for other activities. We would note that none of the large buyers appear to have been selling in a meaningful way, but their absence from the market had an impact. Supply surged in late February and early March, headlined by a massive $40B CVS deal, the third largest offering ever. The market struggled to absorb the increased issuance, especially at the short end of the curve, and moved wider as a result.

Fundamentals, as we noted in our 2018 outlook, have been improving following a multi-year deterioration. Financial leverage has stabilized and is expected to have declined in the first quarter. Consensus forecasts for the S&P 500 Index call for 7% revenue growth and 18% earnings growth, driven by higher oil prices, increased global GDP growth, and dollar weakness. Tax reform created a short-term technical pressure, but the fundamental impact on IG Corporates should be positive. IG companies will benefit from reduced tax rates without the offsetting impact of lowered interest deductibility. Further, the ability to repatriate overseas cash will reduce the need for issuance, slowing debt growth.

The year-to-date underperformance of the asset class should present opportunities. With supportive fundamentals, we can look to take advantage of cheaper valuations across the sector. While the technical environment remains uncertain, annual supply is typically front-loaded, meaning the supply pressures should ease over the course of 2018. As IG has cheapened relative to other sectors, we expect the market to reevaluate its prospects.

HIGH YIELD

The high yield sector started the year strong with a positive January return, but turned negative in February and March as heightened market volatility and rising rates took their toll. Despite the first quarter's overall negative return, the sector held up quite well relative to other fixed income asset classes including investment grade corporates. By credit quality, the longer-duration BBs (-1.60%) underperformed the most followed by Bs (-0.55%). The positive return of CCCs (+0.30%) shows that interest rates, not credit, prevailed as the predominant risk factor during the quarter.

Wirelines (+1%) was the top performer among industries. One of last year's underperformers, the industry was boosted by Frontier Communications' beneficial implementation of some capital structure arbitrage. Retail (+0.93%), another trouble spot in 2017, also did well, as did healthcare (+0.54%), which has been unstable over the past few years on the fate of Obamacare. Smaller segments of the index that also posted positive results included tobacco (+1.92%), aerospace defense (+0.40%), refiners (+0.39%), and diversified manufacturing (+0.24%). In contrast, financial institutions (-2.50%) was among the weakest performers due to the flattening yield curve. Restaurants (-2.75%) were down significantly, and Supermarkets (-2.33%) continued to be plagued by the "Amazon effect." Slowing sales adversely affected automotive (-2.26%), while fears of rising interest rates contributed to weakness in home construction (-2.17%).

Fundamentals remain positive, and broad-based across industries. The high yield issuer universe continues to post solid earnings and sales metrics and economic growth in the U.S. and globally provides a supportive backdrop. March's issuer-weighted default rate did jump up to 3.9% (12-month trailing), but the directional trend continues to be lower with a projected default rate of 1.7% for March 2019. Areas of concern, where default forecasts are highest, still include media – advertising, printing, & publishing, retail, and consumer non-durables. Additionally, we are watching autos as a potential area of stress.

From a technical perspective, the main driver has been mutual fund flows that were decidedly negative (-$19.2 billion) in the first quarter as risk-wary investors avoided the market. On the supply side, issuance was light in the first quarter at $72.7 billion gross ($12.5 billion net) and well off of 2017's pace. January had been relatively strong in terms of issuance but the subsequent volatility and backup in rates also kept issuers on the sidelines.

Valuations continue to be the overriding concern. Despite some widening in March, there was minimal movement in spread levels over the quarter. The high yield index ended March with an option-adjusted spread (OAS) of +354 bps, only 11 basis points wider than at the end of 2017 (+343 bps). Yield to worst ended the quarter at 6.19% compared to a year-end value of 5.72%, but that rise is more indicative of the backup in rates than credit concerns.

While the fundamental backdrop remains favorable for high yield, at current valuation levels there is no buffer to help protect on the downside for a poor performing credit. Even though we are not quite at the end of the credit cycle, we are at the tighter end where the weaker credits are the most punished with any bouts of volatility. With idiosyncratic risk so elevated, industry and credit selection has been and will continue to be the key driver for outperformance going forward.

continued

BANK LOANS

Bank loans delivered a positive return in the first quarter, outperforming the mostly negative returns of other fixed income asset classes. In a period of heightened market volatility and rising interest rates, the asset class demonstrated the importance of its floating rate feature and corresponding low correlation to fixed-rate securities.

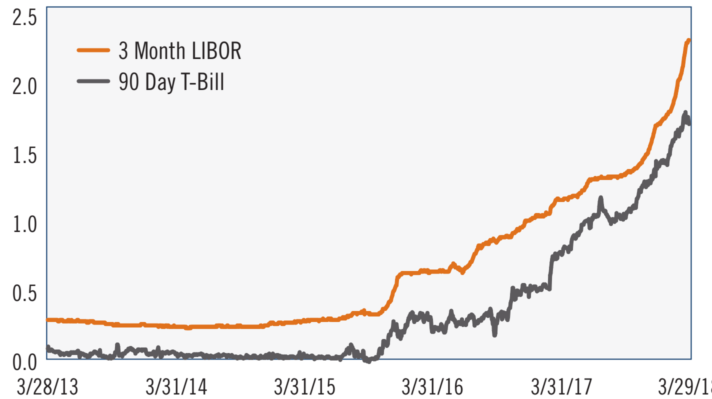
On a quality basis, CCCs (+2.75%) outperformed over the quarter, followed by Bs (+1.49%) and BBs (+1.17%). Defaulted loans had a negative return. On an industry basis, food & drug retailers (+3.28%), retailers (+2.62%), and cosmetics (+2.6%) were the quarter's top performers while aerospace & defense (+0.45%), containers & glass products (+0.95%), lodging & casinos (+1.06%), and business equipment & services (+1.07%) lagged, albeit all with positive returns. Oil & gas (+1.74%) also continued to outperform. The effective yield for loans at quarter end was 5.12%.

Technicals softened toward the end of the quarter due to a high level of net new issuance driven by an increase in M&A transactions. Repricings continued to dominate use of proceeds, though the pace of repricings may start to slow. On the demand side, mutual fund flows experienced a reversal in the first quarter from a negative $3.7 billion in the fourth quarter of 2017 to a positive $3 billion. The rising interest rate environment, coupled with a higher current yield relative to most other income options, has generated strong demand across all buyers.

Demand from CLO creation, though down from last quarter, was a still-robust $32 billion in the first quarter. We are following an event closely that may affect CLO demand. In a post-quarter development (April 5), the U.S. District Court for the District of Columbia vacated the risk-retention rule for open-market U.S. CLOs. This rule, enacted post the Financial Crisis, had required CLO managers to own at least 5% of each CLO structure they managed. Smaller managers who were unable to meet the 5% requirement may now reenter the market, thereby boosting CLO demand in the near term.

Three-month LIBOR, the benchmark rate against which bank loans periodically are reset, has risen steadily over the past few years, jumping over the first quarter from 1.69% to 2.31%. LIBOR is expected to rise as the Fed hikes, along with other short-term rates (see exhibit). While a rapid rise in LIBOR often signals financial market stress, a heavy issuance of U.S. Treasury bills for deficit funding has increased supply in the first quarter while changes in tax reform and repatriation has dented the demand for short-term assets by large corporate buyers with overseas holdings. We believe these factors have accelerated the recent rise in LIBOR and do not reflect market stress. While the increase in LIBOR benefits bank loan investors, there ultimately could be an impact on the ability of borrowers or issuers to service their debt. Higher LIBOR rates may also affect the ability of CLOs to meet their return targets.

SHORT-TERM INTEREST RATES



Source: Bloomberg, L.P.

Past performance is no guarantee of future results.

Broad-based fundamentals for the bank loan issuer universe are favorable. EBITDA growth remains positive, maturity schedules have been pushed out, and the U.S. economic backdrop is supportive. We are watching interest coverage ratios, however, which could pose a problem for the most levered deals. Roughly 7% of the market has a coverage ratio of 1.5x and another 22% are between 1.5x and 3.5x. The default rate did increase in the first quarter, from 2.05% to 2.42%, mainly due to iHeartMedia. There is still idiosyncratic risk and areas of stress include retail, wirelines, and pockets of healthcare. Overall, we are not expecting a significant uptick in defaults within the next year and expect the default rate to be in the area of 2.5% by year end. The degradation in underwriting continues to be a concern and ultimately may hurt long-term recovery rates.

We remain constructive on the bank loan asset class. Though spreads have tightened due to high levels of demand, price weakness has been more than offset by the steady increase in three-month LIBOR. Bank loans essentially have done what they are expected to do, which is to provide a hedge against rising interest rates as well as attractive income. While bank loans are subject to the behavior of interest rates, the themes we are attentive to as we enter the second quarter are the repeal of the risk-retention rule and the rise in LIBOR and their broader implications.

EMERGING MARKETS DEBT

Emerging market (EM) bonds experienced a wide dispersion of returns in the first quarter with negative returns on hard currency sovereign and corporate indices compared to a strong positive return for the local market index. The JP Morgan GBI-EMGD Index (local market debt) returned 4.42% in the quarter boosted by strong performance from South Africa (+13.29%) on an improved political outlook, and Mexico (+10.88%) reflecting higher real rates and a more optimistic outlook for a new NAFTA agreement. Laggards within local markets debt were Argentina (-4.5%), Philippines (-4.7%), and Turkey (-4.6%).

continued

In hard currency bonds, the JP Morgan EMBI Global Diversified Index (USD sovereign) returned -1.74% and the JP Morgan CEMBI-BD Index (USD EM corporate) returned -1.12% in the quarter. Within sovereign and corporate bonds, the underperformance of higher quality and long duration bonds reflected their interest rate-sensitivity as the U.S. Treasury curve shifted sharply up and flattened during the quarter. Wider spreads also contributed to the negative performance. Sovereign index spreads widened by 18 bps during the quarter to 302 bps while corporate index spreads widened by the same amount to 238 bps. Venezuela (+11.6%) and Lebanon (+2.5%) were the top performing country indices while Argentina (-5.24%) and Ecuador (-3.58%), among the larger issuers, meaningfully lagged.

EM technical conditions moved from positive to neutral during the period as there was a deluge of sovereign issuance alongside steady corporate issuance. Meanwhile, strong investor inflows at the start of the year moderated in the back half of the quarter as a result of heightened investor concerns over U.S. rates, global trade policies, and modest softness in the March global PMI data. Technical conditions should remain supportive in the second quarter as sovereign supply was front-loaded and reinvestment flows are set to increase.

Fundamentals remain supportive. However, global growth is likely peaking for this cycle as evidenced by the softer global PMI data and, as a result, fundamental improvements probably will plateau in 2018. Gradual developed market (DM) monetary policy tightening will act as a headwind to growth, especially toward the back half of 2018 and into 2019. Global trade trends may also adversely affect growth although we think that rational agreements ultimately will be negotiated.

EM valuations and macro concerns with regard to trade policies and DM rates remain key risks. However, the fundamental case for EM remains intact and should support valuations and provide opportunity for EM assets to provide competitive fixed income returns. This is especially the case in local markets as additional U.S. dollar weakness is likely over the remainder of 2018 given an expected widening in the U.S. current account and fiscal deficits.

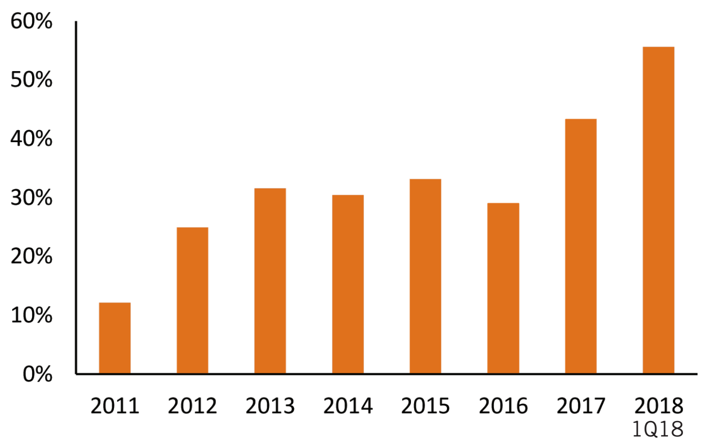
SECURITIZED PRODUCT

Securitized product outperformed the U.S. Aggregate Bond Index as well as corporate bonds during the first quarter due to less sensitivity to the global macro environment. Within securitized product there was mixed performance during the quarter with non-agency residential mortgage-backed securities (RMBS) and asset-backed securities (ABS) leading the way followed by agency mortgage-backed securities (MBS) and commercial mortgage-backed securities (CMBS). Spreads were slightly wider across the market.

Fundamentals remain positive across the securitized product sectors. Low unemployment, strong consumer confidence, and a growing economy have had a positive impact on consumer credit, housing, and commercial real estate. U.S. consumers are the primary obligors within ABS and RMBS securitizations. To date, expected pool losses have been performing well within our expectations and issuers have continued to tighten their underwriting standards. Commercial real estate continues to benefit from ample sources of capital.

From a technical perspective, the backdrop for the securitized product market continues to be positive. The ABS and RMBS market ended the first quarter with negative net supply. The CMBS market continues to issue more Single Asset Single Borrower (SASB) allowing for better due diligence and flexible structures.

SASB ISSUANCE AS % OF COMBINED SASB AND CONDUIT ISSUANCE



Source: Commercial Mortgage Alert, Deutsche Bank

Agency MBS had strong net issuance due to the strong housing market. It will be interesting to see how the market reacts to the Fed's MBS portfolio run-off in 2018 and its ability to absorb the extra supply.

Given the fact that spreads within the mezzanine and subordinate classes of the capital structure remain tight versus the senior classes, our investment thesis to stay up in credit quality continues.

Within ABS, we continue to favor the sub-prime auto, unsecured consumer loans, timeshare, and whole business sectors of the market. The above one-off sectors of the ABS market were the best performing sectors on an excess return basis according to the ICE BofAML ABS Index. With respect to CMBS, from a relative value standpoint, we have continued to focus any new investments within the SASB space. SASB transactions afford us the ability to analyze one property type and invest deeper in the capital structure. The other option that SASB deals offer is

continued

the ability to invest in floating rate product. If the Fed's forecast rate moves in 2018 come to fruition, our underlying deals will have their coupons reset higher.

We continue to overweight non-agency RMBS versus Agency MBS on the basis of incremental carry, naturally shorter durations, and high levels of credit support. Spreads have been very stable despite the risk-off tone in other sectors. We like non-rate-sensitive non-agency mortgage collateral pools. They offer better risk-return profiles versus traditional agency MBS pools. We believe we are in the early stages of the residential credit cycle and have been taking up our non-agency RMBS positions as a result.

TAX-EXEMPT MUNICIPAL BONDS

Municipal bonds posted a first-quarter loss (the first since 2008) as market volatility returned and the initial impacts of tax reform legislation unfolded. In contrast to last year, there was little difference in performance across the investment grade rating tiers. Yield curve performance was more variable with shorter-maturity bonds outperforming longer-dated paper.

Facing the potential loss of the ability to advance refund their higher-cost debt, issuers rushed to the market before year end. The result was a sizable spike in supply levels in December followed by a much slower pace of new supply through the first three months of 2018. At the same time, mutual fund inflows weakened as market volatility and rising U.S. Treasury yields spooked investors. Concern over future demand by banks and insurance companies with the lowering of the corporate tax rate to 21% also contributed to a more cautious market. Overall, however, the technical picture for municipals remains positive as lower supply has helped offset some weakening demand.

For more detail on tax-exempt bonds in the first quarter, including our outlook, please refer to Newfleet's 1Q18 Municipal Bond Market Review.

OUTLOOK

We continue to see value in spread sectors and expect them to benefit from the projected improvement in global growth this year. Sound and improving fundamentals, strong technicals, and still-accommodative central banks remain supportive. Recognizing that valuations are fair to rich in many areas of the fixed income market, selection and positioning within sectors is critical.

There are, of course, potential risks to our outlook and the global economy. Bouts of volatility are likely to persist with the ebb and flow of inflation fears, the assessment of future rate hikes by the Fed, and the unprecedented retreat from quantitative easing by the most influential central banks. Other risks remain including oil price volatility, geopolitical tensions, economic developments in China, the course of the U.S. dollar, and the more recent threat of trade wars.

As always, we believe it is important to stay diversified, have granular positions, and emphasize liquid investments. We continue to look for opportunities in all sectors of the bond market, striving to uncover any out-of-favor or undervalued sectors and securities. With strong demand for fixed income by investors and a supportive environment, spread sectors continue to offer attractive investment opportunities to investors searching for total return and yield.

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. It does not include fees or expenses. The Intercontinental Exchange (ICE) Bank of America Merrill Lynch (BofAML) ABS Indices is a family of indices that measures the performance of the various segments of asset-backed securities. 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.

VIRTUS INVESTMENT PARTNERS

Distributed by **VP Distributors, LLC,** member FINRA and subsidiary of Virtus Investment Partners, Inc.