Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

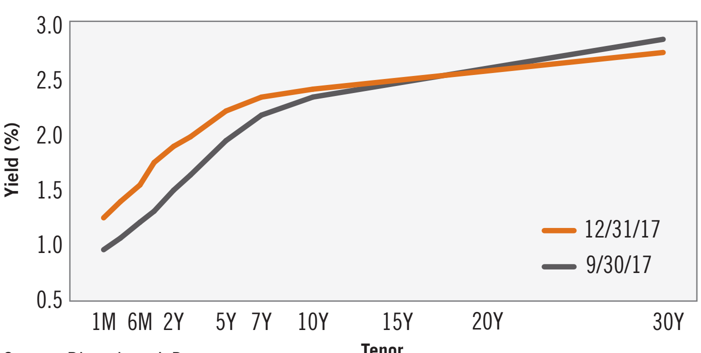
This piece provides a sector-by-sector review of the fourth quarter by members of Newfleet's multi-sector team. For our views on the year ahead, please refer to Newfleet's 2018 Fixed Income Market Outlook.

The overall positive tone for fixed income spread sectors continued into the fourth quarter with short-lived bouts of increased volatility in October and November. Challenges to the status quo included continued geopolitical tensions and the turbulent political climate in Washington, D.C. During the quarter, the U.S. dollar remained weak and oil prices moved higher. In a long-elusive legislative win for President Trump, an extensive tax reform package was passed.

As expected, the Federal Reserve raised its target rate at the December FOMC meeting to a range of 1.25%-1.50% and further indicated three additional hikes in 2018. The Fed's plan to reduce the size of its balance sheet started in October, and Jay Powell was named successor to Janet Yellen as Fed chair effective February 3.

The yield on the 10-year U.S. Treasury ended the quarter at 2.41%, close to its level at year end 2016 (2.45%). During the quarter, yields were higher up through the 15-year part of the curve and slightly decreased on the long end. The yield curve flattened. Subdued inflation and foreign demand supported the longer-dated securities.

U.S. TREASURY YIELD CURVE



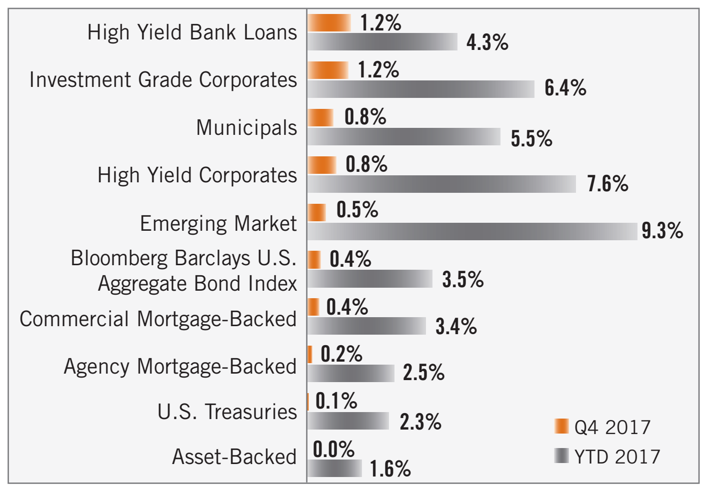
Source: Bloomberg L.P.

A resilient U.S. economy posted third quarter annualized GDP growth of 3.2% following 3.1% growth in the second quarter. A firm labor market (October unemployment at 4.1%), stable housing sector, and historically high consumer confidence provided a positive backdrop. Inflation, however, remained below target and wage growth was sluggish. Globally, synchronized growth has taken hold and the euro zone recovery has exceeded expectations. The European Central Bank extended its quantitative easing program at least until September 2018 but halved its monthly purchases from €60 billion to €30 billion.

FIXED INCOME SECTOR PERFORMANCE

Most spread sectors outperformed U.S. Treasuries during the fourth quarter as spreads tightened and interest rates remained low. Still-accommodative monetary policy by the major central banks, a favorable global growth outlook, and better-than-expected Chinese data all provided a positive backdrop. Moderate economic growth in the U.S., sound and improving credit fundamentals, and strong technicals also supported spread sector outperformance, as did the persistence of the global demand for yield.

FIXED INCOME SECTOR PERFORMANCE



Performance as of December 31, 2017.
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

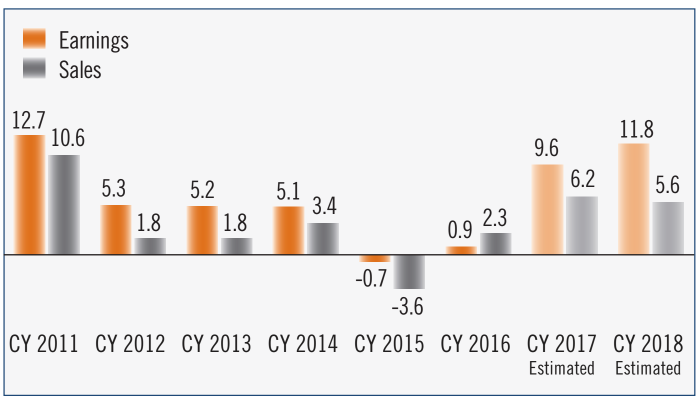
Investment grade corporate bonds generated excess returns of 0.99% in the fourth quarter (1.17% total return), the ninth consecutive quarter with positive excess returns. For the full year, the sector generated excess returns of 3.46% while posting total returns of 6.42%. The option adjusted spread on the Barclays Corporate Index ended the quarter at 93 basis points (bps), 8 bps tighter for the quarter and 30 bps tighter for the year. Spreads will begin 2018 at fresh ten-year lows, breaking through the previous post-Financial Crisis low of 97 bps in 2014. As is typically the case, spreads and yields exhibited negative correlation in the fourth quarter. While spreads were 8 bps tighter, the yield increased by 9 bps to 3.25%. This yield is centered on the 2017 range (3-3.5%) and maintains a healthy advantage over global alternatives such as European corporates (0.76%) and Asia-Pacific corporates (1.13%).

Favorable supply and demand dynamics persisted in the fourth quarter and drove 2017's strong performance. For the full year, net supply declined 10% year-over-year to $600 billion and was overwhelmed by demand from mutual funds, foreign buyers, life insurers, banks, and pension funds. Mutual funds represent just 16% of the buyer base, but reported inflows of $260 billion (16% of AUM). Foreign buyer demand (approximately 30% of the buyer base) was estimated at $200 billion in the first half of 2017 alone (full-year figures not yet available).

The fourth quarter differed from the rest of 2017 in terms of the changing trajectory of fundamentals. In our previous quarterly outlooks, we noted a multi-year deterioration in several key credit metrics. However, financial leverage stabilized earlier in the year and started to move lower in the second half. Third quarter revenue and earnings growth rates (S&P 500) exceeded expectations at 5.3% and 7.1%, respectively. Consensus estimates call for 11% earnings growth in Q4 and 11.8% for 2018. With stable net issuance, double-digit earnings growth, and potential cash repatriation, we would anticipate fundamentals to continue to improve in early 2018.

S&P 500 EARNINGS AND REVENUE GROWTH

2011-2018



Source: FactSet

Past performance is no guarantee of future results.

Tax reform is almost universally positive for the sector. Investment grade companies will benefit from a lower tax rate without the offset of reduced interest deductibility. Further, the repatriation holiday disproportionately impacts investment grade companies as the majority of overseas cash holdings are found in large-cap technology and pharmaceutical firms (e.g., Apple, Microsoft, and Google). This repatriated cash should reduce the need for new issuance in 2018 and could potentially be used to repay upcoming maturities.

Though a repeat of 2017 performance is unlikely in the context of tight valuations, we believe the investment grade market has sufficient headroom to generate positive excess returns in 2018. Investors are receiving an attractive yield relative to global alternatives, and spreads provide more than adequate compensation for "worst-case" default and downgrade scenarios.

HIGH YIELD

The high yield market posted a positive return for the fourth quarter but lagged the first three quarters of 2017. Rising interest rates aside, a few hard-hit industries, namely wirelines and healthcare, drove the market down in November to dampen the quarterly result. On a credit quality basis, securities rated CCC (+1.02%) performed best over the quarter followed by BBs (+0.39 %) and Bs (+0.37%).

As the global economy continues to gain strength, basic industry had some solid performers during the quarter including chemicals (+1.56%) and metals & mining (+1.49%). Boosted by higher commodity prices, the energy complex also provided strong returns with refiners (+3.34%) and independent energy (+2.76%) the standouts. Other noteworthy performers included the smaller tobacco industry (+3.40) and utilities (+2.45%). Supermarkets (+4.59%), last quarter's laggard, made an impressive comeback. Underperformers over the quarter with negative returns were wireless (-2.63%), wirelines (-1.83%), and consumer products (-1.72%).

Fundamentals continue to improve. The issuer-weighted default rate ended the year at 3.3% and Moody's expects it to decline to 2.4% by the end of 2018. Media – advertising, printing & publishing, retail, and consumer durable goods are the three industries forecast to have the highest one-year default rates. Earnings and revenue growth have not been phenomenal, but the 6% to 7% range on both of these metrics is acceptable, especially with the expected pickup in the economy. Even though leverage has creeped up over the past few years, the absence of a maturity wall and a high interest coverage ratio mitigates concerns over debt levels. Retail remains the well known trouble spot among industries as brick and mortar companies continue to lose business to the online competition ("Amazon effect"). A declining subscriber base continues to take a toll on wirelines, an industry that is struggling with challenges to the long-term sustainability of its business model. There are also pockets of concern in healthcare, which faces unknowns as long as the fate of Obamacare hangs in the balance.

Technicals have also been fairly positive. Even though gross issuance has been high at $328 billion for the year, net issuance has been relatively small ($55 billion) taking into account calls, tenders, and maturities. Net supply for the full year has actually been negative, a situation we have not seen since 2011. Even though there have been substantial outflows from high yield funds, the continued global search for yield has attracted money into the space on any temporary weakness.

Valuations continue to be the overriding concern and the biggest obstacle to dramatic positive total return going forward. The high yield market is in a very different place than it was going into 2017. At 12/31/17, the high yield market had an average price of $100.91, a 5.72% yield to worst, and an average

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option-adjusted spread (OAS) of +343 basis points. This compares to an the average price of $99.80, a yield to worst of 6.12%, and an OAS of +409 basis points at the start of 2017. At current valuation levels, there is no buffer to help protect on the downside for a poor performing credit, which is the reason why industry and credit selection is critical.

For Newfleet's outlook on high yield, please refer to our 2018 Corporate High Yield Outlook.

BANK LOANS

The bank loan market posted a respectable return in the fourth quarter, supported by favorable fundamentals and strong technicals. The loan market rally over the past two years has left little room for price appreciation, so the incremental return has come predominantly from income. While the fourth quarter was the second best quarter of the year on a total return basis, market value returns have been slightly negative throughout the year including the fourth quarter. In terms of industry sectors, notable outperformers during the quarter were publishing (+1.94%), energy (+1.69%), automotive (1.60%), and utilities (+1.58%). The laggards included cosmetics (-3.15%), home furnishings (-1.55%), and surface transports (-0.87%). By credit quality, BBs performed in line with Bs (+1.09% for both) while CCCs (+2.85%) continued to lead in the risk-on environment. Lastly, second lien loans outperformed first lien. The effective yield for loans at quarter end was 4.86%.

Overall fundamentals remain strong, even though defaults ticked up significantly in the fourth quarter. The six defaults, the majority of which occurred in November, brought the loan default rate to a 17-month high of 2.05% at quarter end, up from 1.53% at the end of the third quarter. However, the trailing 12-month default rate is well below the historical average of 3.1%, which we do not expect the market to pierce until at least late 2019. The loan market otherwise is characterized by improving year-over-year growth in revenues and EBITDA, strong debt service coverage ratios, and a minimal level of distressed debt indicating future defaults. Capital markets continue to be wide open to meet financing needs. From an industry perspective, we do have concerns for those industries that are going through a secular change such as retail, wirelines, and possibly healthcare. From a more global point of view, we remain cautious about the credit underwriting cycle and the deterioration of credit quality in the new issuance vintage. Giving up structural protections may negatively affect default and recovery levels in the next cycle.

Technicals continue to be supportive with strong CLO issuance driving demand and refinancings dominating supply. CLO creation was $34.6 billion in the fourth quarter, bringing the 2017 total to $117 billion, the second highest issuance level on record. CLO issuance compensated for weak retail flows of -$5.0 billion in the fourth quarter although full-year flows were strongly positive at $14.1 billion on strong first half fund flows. Near-par prices and range-bound U.S. Treasuries have dampened retail interest in the asset class. On the supply side, gross issuance in the fourth quarter was $241 billion with net new issuance (after refinancings and repricings) of just under $60 billion. The corresponding numbers for the full year were $974 billion and $230 billion.

Valuations are fairly rich, with the tightest spreads we have seen since the Financial Crisis. However, we believe there is a case to be made for the floating rate asset class given the benign fundamental backdrop and the prospect of further rate increases by the Federal Reserve as it also starts to unwind its balance sheet.

For Newfleet's outlook on bank loans, please refer to our 2018 Bank Loan Market Outlook.

EMERGING MARKETS DEBT

Emerging market (EM) bonds continued to perform well in the fourth quarter, and posted strong returns for the full year led by local currency bonds. Overall, the JP Morgan GBI-EMGD Index (local debt) returned 0.82% in the quarter and 15.21% for the full year. The JP Morgan EMBI Global Diversified Index (USD sovereign) returned 1.16% and 10.26% for the respective periods while the JP Morgan CEMBI-BD Index (USD corporate) returned 0.68% and 7.96%, respectively.

In hard currency sovereign bonds, lower quality outperformed higher quality and long duration bonds outperformed in both the quarter and the full year reflecting investors' thirst for yield and low overall market volatility. In the quarter, the Africa region (+3.30%) led returns and a number of smaller issuers were also among the top performers including Ecuador (+9.14%) and El Salvador (+5.67%). Of the larger issuers, Argentine bonds (+2.86%) performed well. Venezuela, which defaulted, was the clear laggard (-28.46%) in the period, along with Lebanon (-1.11%).

EM market technical conditions remained positive despite a large amount of supply as net inflows into the sector continued to be healthy. Full-year gross new issue supply was at record levels for both sovereign ($175bn) and EM corporate ($480bn) issuers, but net supply was manageable. Meanwhile, full-year EM fixed income fund flows were a record $112.8bn.

Fundamentals across EM countries are broadly improving and, in our view, EM economies are generally earlier in the economic cycle than the U.S. Argentina, Brazil, and Russia all emerged from recession in 2017 and are leading the recovery phase. Rate-easing cycles across EM are largely done, and we broadly see monetary policy moving toward neutral and possibly tightening in some situations in 2018. For the first time in several years, EM and developed markets entered into a period of synchronized growth in 2017, and the most recent global

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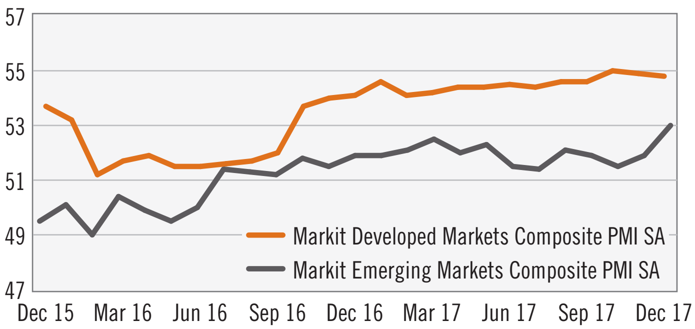
Composite Purchasing Managers' Index (PMI) indicates the trend remains intact (see chart below). According to Bloomberg, overall EM GDP growth is forecast to accelerate to 5.0% in 2018 from an expected 4.7% in 2017 led by the Latin America and Middle East regions.

COMPOSITE PURCHASING MANAGERS' INDEX (PMI)



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

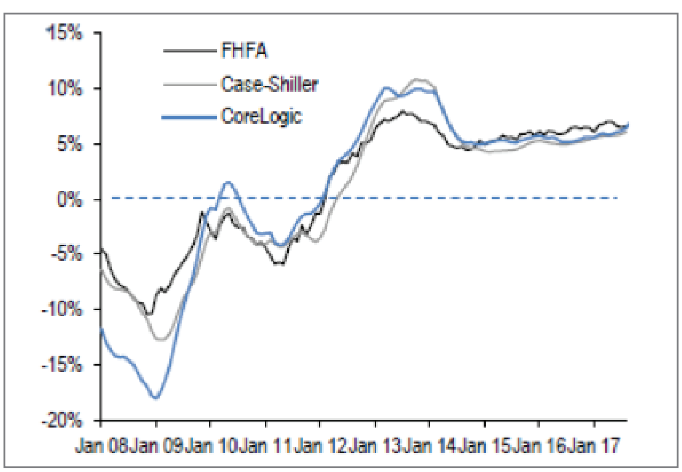
While we see limited room for material spread compression in 2018 given relatively tight valuations on a historical basis, we are optimistic that EM hard currency debt can continue to provide competitive total and excess returns within the fixed income asset class. We base this on the positive fundamental outlook and our macro view that global monetary policy accommodation will only be removed at a slow and deliberate pace.

SECURITIZED PRODUCT

Securitized product had mixed performance during the fourth quarter. Non-agency residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) led the way followed by agency mortgage-backed securities (MBS) and asset-backed securities (ABS). Spreads were mostly unchanged after tightening throughout the first three quarters of 2017.

3 MAJOR INDICES FOLLOW ON A STEADY PACE OF GROWTH

YoY % Changes for Major Home Price Indices



Source: CoreLogic, FHFA, J.P. Morgan

Fundamentals remain positive across the securitized product sector. 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. Low unemployment coupled with a low interest rate environment has enabled borrowers to stay current on their obligations. To date, underlying delinquencies and losses have been very low and performing well within our expectations. Home price indices are up 6% year over year.

Commercial real estate values as measured by Real Capital Analytics Commercial Property Price Index show a 9.1% year-over-year increase.

From a technical perspective, the backdrop for the securitized product market continues to be positive. The ABS and RMBS market ended the fourth quarter with negative net supply. The CMBS market, for the first time since the Financial Crisis, will end 2017 with a positive net supply. 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.

TAX-EXEMPT MUNICIPAL BONDS

Municipal bonds posted a positive return in the fourth quarter driven by strong issuance and uncertainty over the final tax reform package. Faced with the possibility that hospitals, universities, and other private activity bond issuers would no longer be able to issue debt in the tax-exempt market, issuers rushed to market. This proposed element of the tax reform bill ultimately did not make it into the final legislation, but investors were not taking any chances. At the same time, municipalities sought to refinance their higher-cost debt before their ability to advance refund was halted. The rush to complete issuance before year end caused a sizable spike in supply levels. Instead of causing the market to soften, anticipation of limited supply in 2018 provided strong performance heading into the end of 2017.

During the quarter, performance was strongly correlated to positioning along the yield curve as longer-maturity bonds significantly outperformed shorter-maturity bonds. The yield curve flattened as yields on the short end rose in response to the Federal Reserve's rate hikes while limited supply in the long end caused yields in that part of the curve to decline. In addition, lower-rated issues continued to outperform higher quality alternatives as municipal investors still favored yield, causing spreads to remain historically tight.

With the passage of the tax reform bill now behind us, there are still questions as to how lower tax rates may affect the demand for tax-exempt bonds. *For more detail on tax-exempt bonds in the fourth quarter, including our outlook, please refer to Newfleet's 4Q17 Municipal Bond Market Review.*

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OUTLOOK

As we look ahead to 2018, we expect that spread sectors will continue to perform well in the current environment of steady GDP growth, subdued inflation, and a favorable macroeconomic backdrop. We are constructive on spread sectors based on sound and improving fundamentals, strong technicals, and still-accommodative central banks. We recognize, however, that valuations are fair to rich in many areas of the fixed income market. With spreads well inside of long-term averages, issue selection and positioning within sectors is critical.

There are, of course, potential risks to our outlook and the global economy. The unprecedented retreat from quantitative easing by the most influential central banks, which may gain momentum in 2018, is the newest and most prominent risk. We believe that the central banks will take a cautious approach in order to avoid derailing the budding global economic recovery. Among other risks, oil price volatility, geopolitical tensions, economic developments in China, the course of the U.S. dollar, and continued gridlock in Washington, D.C. remain from 2017. NAFTA and other trade negotiations are expected to heat up in 2018, which have the potential to unsettle markets, as do mid-term elections in the U.S. and a busy election calendar abroad.

As always, we believe it is important to stay diversified, have granular positions, and emphasize liquid investments. We will 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 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.