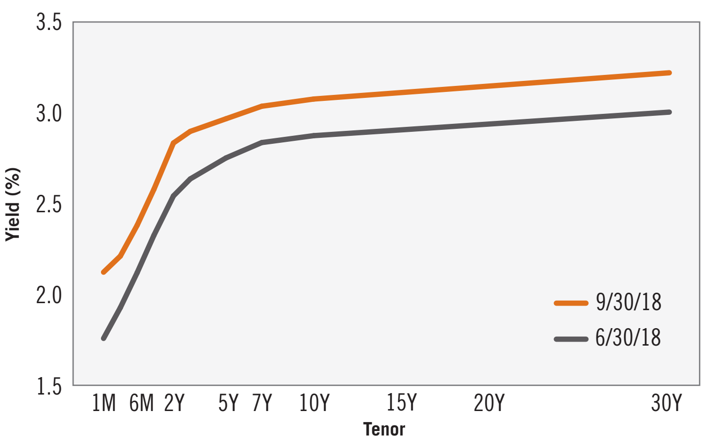
Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

Fixed income investors faced substantially similar market themes during the third quarter as in the prior two quarters of 2018. Market participants continued to wrestle with periods of volatility caused by geopolitical developments, trade rhetoric, mixed global economic signals, and the evolution of quantitative easing programs that began in the aftermath of the now decade-old Financial Crisis. During the quarter, oil prices continued their ascent driven by the outlook for supply/demand dynamics. U.S. economic data stayed on a positive trend, which contrasted with other global economies. Primary inflation readings remained in check, but pressure in key components (i.e., wages) has started to build.

As expected, the Federal Open Market Committee (FOMC) increased its target rate at the September meeting to a range of 2.00-2.25%, its eighth hike in the current tightening cycle. The pace of the Federal Reserve's (Fed) balance sheet adjustment remains as originally deployed. The European Central Bank remains on track to end its monthly bond purchases at the end of 2018 while reinvesting proceeds from maturities and maintaining key policy rates well into 2019 and beyond if deemed necessary by incoming economic data. The Bank of Japan made some minor adjustments to its purchase program during the quarter but no substantial changes are expected for the next 12-18 months.

U.S. TREASURY YIELD CURVE



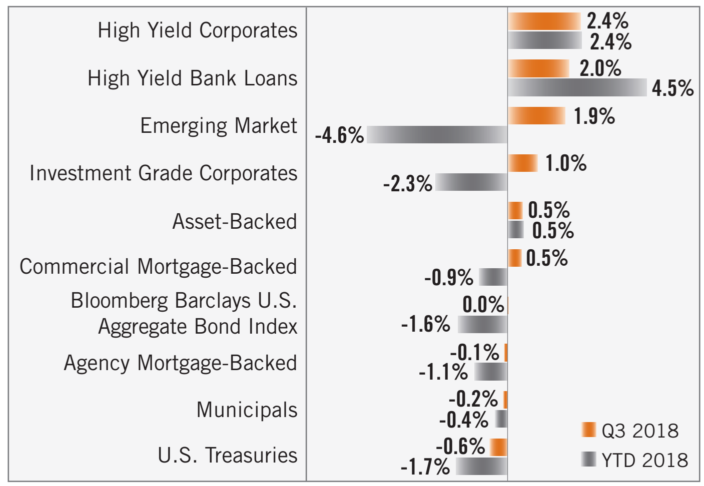
Source: Bloomberg L.P.

During the quarter, yields were higher across the curve though slightly more pronounced at the front end. Overall, the curve flattened. The yield on the benchmark 10-year U.S. Treasury ended the quarter at 3.06% having started the quarter at 2.86%.

FIXED INCOME SECTOR PERFORMANCE

Most spread sectors outperformed during the quarter led by high yield corporates and bank loans, both demonstrating their resilience in a rising rate environment. Across other spread sectors, tightening spreads offset price declines from rising rates to a greater degree for longer duration assets relative to their shorter duration counterparts. Additionally, lower credit ratings outperformed higher quality on a total return basis. Also of note, emerging markets debt (US$ sovereigns) bounced back in the third quarter with a September rally.

FIXED INCOME SECTOR PERFORMANCE



Performance as of September 30, 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.

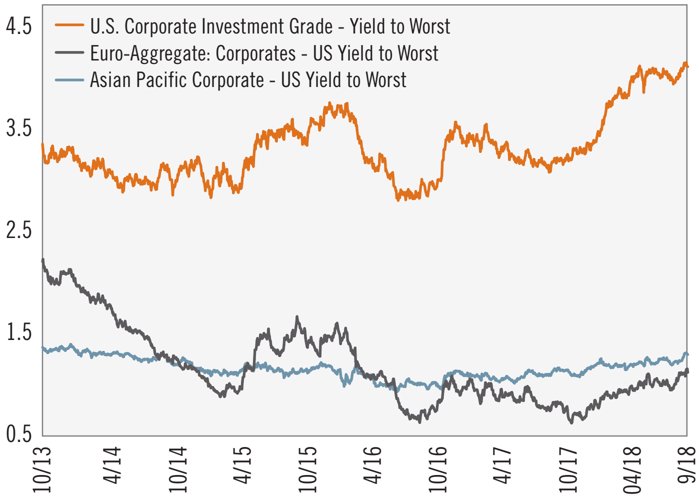
INVESTMENT GRADE

Corporate investment grade (IG) performance improved notably in the third quarter driven by stronger technicals (supply/demand factors), better than expected second quarter earnings, and broad-based strength in economic data. The index excess return (relative to the return on a risk-free investment) for the quarter was 1.69% and the total return was 0.97%. Year to date, total return has improved to -2.33% from -3.3% at the end of the second quarter while the YTD excess return has improved to -0.11% from -1.76%.

As Treasury yields broadly rose in the third quarter, all returns were generated by credit spread performance. IG spreads started at +123 basis points above Treasuries and ended 10 basis points tighter at +113 basis points. This marks the first time in 2018 that we exited the quarter tighter than where we started. IG spreads are now below their three-year and five-year averages, but wide of the 10-year low we saw in February 2018.

The yield in the asset class remains above 4%, as lower spread levels were offset by increased Treasury yields. This has been the first year since 2011 that the IG yield has been sustained above 4%. Although rates have crept up globally, the pickup offered by U.S. Corporate IG to its foreign peers remains at five-year highs. Currently, the European IG market yields 1.09% and the Asian IG market yields 1.25%.

US IG YIELD VS. EURO IG YIELD VS. ASIA IG YIELD



Source: Bloomberg L.P.

To recap the first half of the year, performance was challenged by tighter liquidity as the Fed began reducing its balance sheet, heavy new supply, a substantial increase in U.S. dollar hedging costs for international investors, and repatriation of "foreign cash" by U.S. corporations. However, in the third quarter, we saw a reversal as rates (volatility) stabilized, domestic economic data remained very strong, and other macro concerns faded slightly (e.g., trade war, emerging market fears).

Our outlook for the remainder of the year is cautious optimism. The rally in spreads has certainly reduced some of the attractiveness of IG but fundamental data, especially in the US, has been strong and our belief is that this strength should continue for the rest of 2018 and into next year. The wildcard in our view is the technical factor. On the supply side, there is still a healthy M&A pipeline that could cause elevated IG issuance in the fourth quarter of 2018, while on the demand side we could see international demand for U.S. IG take a step back as it did in the first half of the year.

HIGH YIELD

High yield was one of the best performing sectors in the third quarter, reinforcing historical evidence that high yield can still do well in a rising rate environment. High yield has further showed resilience in the face of heightened emerging markets volatility, perhaps as a "safer" source of yield as investors shied away from the latter. Lower quality continued to drive returns with CCCs (+2.73%) outperforming Bs (+2.29%) and BBs (+2.31%). As one of the few fixed income asset classes with a positive year-to-date return, high yield investors have clearly been more comfortable taking credit risk than interest rate risk.

Among industries, the best performers included those that had been the most pressured over the past couple of quarters. Pharmaceuticals (+4.47%) was the top performer followed by supermarkets (+4.03%), wireless (+3.85%), cable & satellite (+3.69%), and healthcare (+3.13%). At the other end of the spectrum, retail REITS (-0.13%) was the only industry with a negative return. Other bottom performers with less than a 1% positive return were retail (+0.08%), office REITS (+0.68%), and lodging (+0.91%).

Demand continued to outstrip supply, maintaining a positive technical environment for the high yield market. The $40.5 billion of new issuance in the third quarter brought year-to-date volume to $166.7 billion, which is down 34% over the same period last year. On a net basis, high yield activity has totaled just $62 billion year to date, down about 25% year over year. The bulk of supply still seems to be diverted to the bank loan market where flows into loan funds and CLO creation have supported strong demand. Energy accounted for about one-fourth of new issue volume in the quarter and refinancings, which rose to 58.5%, continued to dominate use of proceeds by high yield issuers. On the demand side, flows continued to be negative in the third quarter (-$1.0 billion) though vastly smaller than outflows earlier in the year. So far in 2018, outflows are roughly $25 billion. Negative flows aside, attractive coupons, maturities, refinancings, and the global reach for yield have sustained the demand for high yield.

Fundamentals for the high yield issuer universe are still healthy with second quarter revenue and earnings growth of roughly 10% and 20%, respectively, using the Russell 2000® Index as a proxy. From a ratings perspective, momentum continues to be tilted to the upside in a trend that started in the second half of 2016. The upgrade/downgrade ratio thus far in 2018 is 1.3x by number of issuers and 1.2x by dollar volume. The U.S. issuer-weighted default rate ended September at 3.1%. Continuing a downward trend, the forecast default rate is expected to end the year at 2.5% and decline to 2.0% by September 2019. Media – advertising, printing, & publishing; retail; and consumer durable goods are the areas of greatest concern and where the impact on default rates might be greatest.

Valuations continue to be the overriding concern. Bucking the trend of rising interest rates, spreads narrowed over the quarter. The high yield index ended September with an option-adjusted spread (OAS) of +316 bps – the tighter end of the post-Financial Crisis range – and 47 bps tighter than at the end of the second quarter (+363 bps). Yields have been range bound over the past six months or so. Yield to worst ended the third quarter at 6.24% compared to 6.49% at the end of the June quarter.

Our outlook for high yield continues to be favorable. We expect issuer fundamentals to remain positive, and supply/demand conditions to be supportive. From a macro perspective, trade tensions with China, Italy's debt crisis, and general geopolitical tensions are just a few of the risks that could negatively impact the asset class. Our greatest concern is interest rates. If rates

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continue to back up, high yield may have a difficult time grinding in from current levels. Idiosyncratic risk is high and the margin for error is slim. Industry and credit selection has been and will continue to be the key driver for outperformance going forward.

BANK LOANS

Bank loans was one of the quarter's best performing sectors, extending its streak of now thirteen consecutive months of positive total return. The third quarter produced the strongest quarterly return since the fourth quarter of 2016 as the market bounced back from technically induced weakness in the second quarter in which a wave of supply overwhelmed still-strong demand. The asset class continues to attract investors seeking protection against rising interest rates and higher yield relative to other fixed income options.

The effective yield for loans at quarter end was 5.56% compared to 5.50% at the start of the quarter. The coupon has risen throughout the year with increases in LIBOR, which has more than offset price pressures. All of the year's total return consists of coupon, with the market value component of return flat thus far in 2018.

The theme of lower quality outperforming higher quality continued over the quarter. CCCs (+3.47%) led the way followed by Bs (+1.96%), and BBs (+1.53%) indicating that credit issues have not been at the forefront of investors' concerns. Second lien loans (+2.3%) also outperformed. On an industry basis, the best performers were those that have experienced a recovery, including retail (+3.37%) and home furnishings (+3.35%). Rising oil prices boosted oil & gas (+2.76%) while the smaller surface transport sector (+2.77%) rose on idiosyncratic credit events. Underperformers at the industry level included metals & minerals (+0.04%), radio & television (+0.04%), and beverage & tobacco (+0.09%).

From a technical perspective, the supply/demand balance improved over the quarter. New supply allocated in the third quarter was only $70.4 billion compared with $131 billion in the second quarter, while demand kept a strong pace. CLO issuance, the larger component of demand, was a still-robust $32 billion in the third quarter and, at $101 billion year to date, a 23% increase over the same period last year. Retail fund inflows totaled roughly $2 billion in the third quarter and stand at $11 billion year to date. Though third quarter flows fell short of the previous quarter, the expectation of a December rate hike by the Fed may accelerate investor interest in bank loan funds.

Broad-based fundamentals for the bank loan issuer universe remain healthy. Second quarter revenue and earnings growth, as measured by publicly reporting companies in the S&P/LSTA Index, were up 14% and 12%, respectively. Leverage and coverage levels have subsequently improved.

There were no defaults in the third quarter. The annual loan market default rate decreased during the three-month period from 1.95% to 1.81%, well below the historical average of 3%, and down from the three-year high of 2.42% at the end of the first quarter. Distressed credits trading at $80 or less, a warning sign for future defaults, are less than 2% of the overall market. In sum, the bank loan market has functioned well against a favorable U.S. and global economic backdrop, minimal near-term maturities, and open capital markets.

From a price standpoint, the bank loan market ended the quarter at 98.61, up from the previous quarter end of 98.05 and the year's low of 98.04 on July 2. Approximately 60% of loans are now trading at par. Price appreciation potential thus is limited as we move toward year end, with expectations for income to be the primary source of returns.

With the Fed poised for another interest rate hike and the recent breakout of the 10-year and 30-year rates, our outlook for bank loans remains positive. This is the type of environment where the bank loan asset class should perform well, as a hedge against rising rates and a source of attractive income. Demand is likely to remain strong from both institutional and retail investors. At the same time, we expect a continuation of positive trends for bank loan issuers in terms of earnings, balance sheets, and the prospects for limited defaults with GDP growth in the area of 3%. Valuations remain an overriding concern as the margin for error is slim with spreads well inside long-term averages. As an ongoing concern, we continue to be selective in new issue participation given the weakening in underwriting that has occurred and its implications for recovery rates in the future.

EMERGING MARKETS DEBT

Emerging markets (EM) debt, as measured by the JP Morgan EMBI Global Index (US$ sovereign), bounced 1.9% in the third quarter. The push higher came late in the quarter when the sovereign index produced a 2.6% return from September 11 to September 28 after coming close to hitting a new bottom for 2018 on September 11 when the YTD return was -5.9% (slightly better than the 2018 low of -6.1% on June 19). During the post-Financial Crisis time period, buyers tend to emerge whenever the all-in yield to maturity (YTM) approaches 7.0%, which happened on September 11.

We can point to three credit-specific events in the latter part of September that contributed to the rally, in addition to outright cheap valuations. First, Argentina received an expanded and more favorable IMF package. Second, the central bank in Turkey delivered a 625 bps interest rate hike that investors had long called for to address inflation concerns. Third, the market-preferred presidential candidate in Brazil, Jair Bolsonaro, enlarged his lead in election polls leading up to the first run-off scheduled for October 7. On the macro front, the U.S. Fed delivered an expected 25 bps rate hike on September 26 with an accompanying statement that was perceived as slightly dovish.

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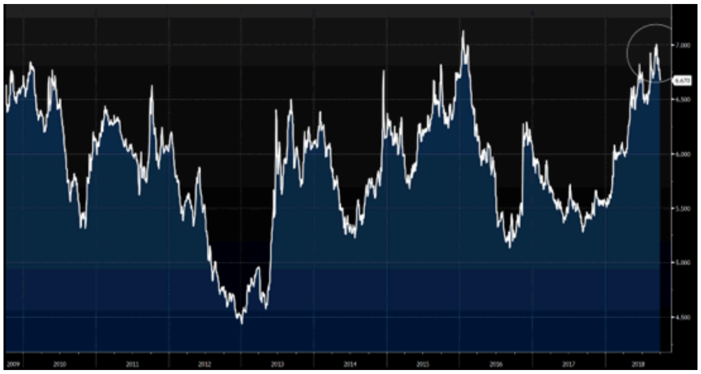
JP MORGAN EMBI GLOBAL INDEX YIELD
(10/1/2009 to 10/1/2018)



Source: Bloomberg L.P.

A number of smaller frontier countries led performance during the quarter paced by Pakistan (+8.5%) and Ecuador (+8.2%). More broadly, by region, the Africa index returned 3.0% and the Middle East index returned 4.0%. Among the top ten country exposures that comprise 56% of the Index, Brazil (+2.8%) and Indonesia (+2.4%) led the way. Zambia (-16.7%) and Costa Rica (-5.2%) were the worst performers in the quarter. Among the larger countries, despite closing the quarter strongly, Venezuela, Turkey, and Argentina all had negative returns in the period at -2.2%, -0.9%, and -0.1%, respectively.

Corporates fared slightly worse than sovereigns during the period with a return of 1.3% on the JP Morgan CEMBI-BD Index (USD EM corporate). The local market index (GBI-EM Global Diversified) return was -1.83%, pulled down by a -35% return on the Argentine local market index and a -27% return on the Turkey local market index. Performance in local markets was otherwise somewhat mixed with Mexico's (+5.5%) top performance reflecting some recovery post the early-July election of Andres Manuel Lopez Obrador as president.

Is the yield approaching 7% an all-clear buy signal? We believe the market is moving into a bottoming phase. Longer term, the sustainability of the rally depends upon greater clarity on the following country-specific and macro risk factors:

> EM countries with large borrowing needs: Turkey is in focus now that Argentina's funding has been covered for the next 12 months. While Argentina's stability remains fragile and depends on the government meeting aggressive fiscal tightening requirements imposed by the recent IMF funding program, we think Argentina is past the worst of recent pressure for now. We expect Argentina to continue to comply with IMF demands needed to keep the remaining tranches of their recent funding package. While Turkey remains defiant toward the West, we expect it to come to terms with the Western-dominated multi-lateral financial institutions simply because lack of access to private markets has left them with no choice. During the interim, we expect continued volatility.

> China and the escalating trade war: We are concerned that the U.S. will raise tariffs to 25% at year end on over $200bn of China's exports to the U.S. and may take additional steps in 2019. The impact on China's economic growth is estimated to be -0.5 to 1.0% and there will be negative spillover effects on EM countries generally. The Chinese yuan has already depreciated meaningfully year to date, putting pressure on regional currencies and manufacturing competitors.

> Italy: The country's fiscal and debt dynamics are unsustainable and the current populist government has just defied the EU budget constraint target.

> The U.S. Fed: While we are concerned that the Fed overtightens, this would be a medium-term event if it were to occur.

> ECB monetary policy normalization: We expect the pace to remain glacial, including minimal balance sheet tapering beginning in February 2019 with policy rate hikes thereafter.

In summary, the EM debt market offers attractive absolute and relative value. While the trickle down to total return performance has been inconsistent, our now lower level of exposure affords us the opportunity to seek pockets of value on macro and credit-specific driven bouts of selling pressure.

SECURITIZED PRODUCT

Securitized product continued to outperform U.S. Treasuries during the third quarter of 2018, and credit spreads held firm. However, securitized product underperformed their corporate surrogates for the quarter. This was due primarily to corporate bonds recovering some of their second quarter spread widening. Asset-backed securities (ABS), non-agency residential mortgage-backed securities (RMBS), and commercial mortgage-backed securities (CMBS) continued to benefit from strong investor demand.

Over the past quarter, U.S. Treasury rates moved higher and the curve continued to flatten between the two-year and the 10-year Treasury. Credit concerns remained low and the ever-flattening yield curve continued to make short average life securitized product look attractive. In addition, the continued Treasury curve flattening has had very little effect on spreads. At the top of the capital structure of our deals, spreads versus their risk-free counterparts were unchanged to slightly tighter for the quarter. However, subordinate tranches of new issue and secondary deals continued to tighten on a spread basis. There seems to be an insatiable amount of demand for these junior positions as investors continue to search for yield and are comfortable taking on more credit risk.

Fundamentals remain positive across the securitized product sector. We have muted concerns about housing fundamentals despite deteriorating affordability in the housing market. Home prices will continue rising, albeit at a slowing pace as the market expects year-over-year home price appreciation (HPA) to drop

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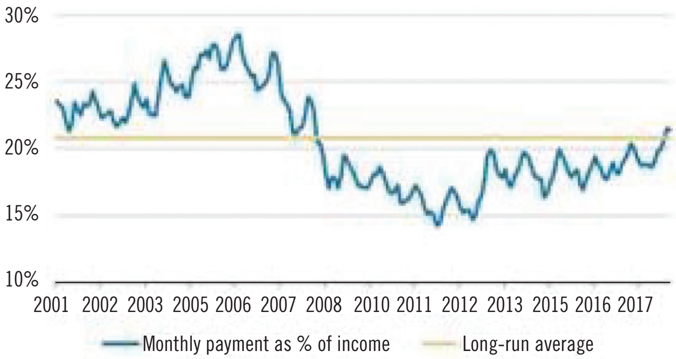
to 5% by year end, down from the current 6% pace. Low unemployment, strong consumer confidence, and a growing economy have had a positive impact on securitized credit.

MORTGAGE PAYMENT TO INCOME RATIO ABOVE THE 20-YEAR AVERAGE...



Source: NAR, US Census Bureau, Freddie Mac, Morgan Stanley Research

...BUT PRIOR PEAKS WERE ACCOMPANIED BY A RISE IN AFFORDABILITY PRODUCTS

Source: LoanPerformance, Morgan Stanley Research

From a supply/demand perspective, the backdrop for the securitized product market continues to be positive. In general, securitized product supply to date is running slightly ahead of 2017 issuance.

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. However, given the current spread pick-up to take on more credit risk, we have and continue to position our book of business higher within the capital stack for new purchases.

With respect to CMBS, from a relative value standpoint, we have continued to focus any new investments within the single asset single borrower (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 the ability to invest in floating rate product. As the Fed's rate increases materialize in 2018, floating rate securities are providing positive total return.

Non-agency RMBS offers value versus agency mortgage-backed securities (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 given their more attractive 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.

Agency MBS slightly underperformed the Aggregate Index during the quarter as investors opted for more yield. Supply was running flat to 2017 and is expected to end 2018 in line with 2017. Given fair spread and potentially more interest rate sensitivity we will continue to focus on non-agency RMBS.

Overall, we expect spreads across securitized product to remain range bound over the fourth quarter. As we head into the fall months, a prudent supply calendar should keep a lid on securitized spreads. Short-duration securitized products still look attractive versus their longer-duration brethren. We will continue to look for one-off opportunities within the securitized product opportunity set to add yield and, more importantly, total return to our overall asset base.

TAX-EXEMPT MUNICIPAL BONDS

Municipal bonds posted a return of -0.15% in the third quarter, largely a result of the negative performance experienced during the month of September as municipal yields followed U.S. Treasury yields higher. For the three months ended September 30, 2018, the intermediate part of the curve produced positive performance while shorter and long maturity bonds underperformed with negative returns. Additionally, lower quality bonds once again outperformed higher quality bonds as investors were willing to take additional credit risk in their quest for higher yield.

The municipal bond market continued to experience lighter new issuance during much of the third quarter, but the favorable technical (supply/demand factors) conditions have softened as slower demand and rising Treasury rates resulted in the quarter's negative performance. Municipal issuers have been constrained to issue debt as the new tax code eliminated their ability to advance refund higher cost debt with new tax-exempt debt, while fiscal austerity measures have also made them reluctant to issue debt. Demand for municipals has been mixed as interest rates have risen and the new tax code has lessened the advantage for banks to own tax-exempt bonds. Individuals continue to invest in tax-exempt securities, favoring investments in tax-exempt mutual funds, ETFs, or separately managed accounts over direct ownership. Banks, on the other hand,

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which had become a sizable buyer of municipal bonds prior to the lowering of the corporate tax rate from 35% to 21%, have continued to reduce their exposure at a steady pace. Overall, the technical picture for municipals remains supportive as lower supply has helped to offset some weakening demand. Looming concerns around an increase in supply levels and investor apathy as interest rates rise could disrupt the strong technical conditions that have been in place for much of the year.

For more detail on tax-exempt bonds in the third quarter, including our outlook, please refer to Newfleet's 3Q18 Municipal Bond Market Review.

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.

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