2022 Fixed Income Market Outlook

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

Dave Albrycht, CFA, President and Chief Investment Officer

It has now been well over a year since 2020's COVID market sell-off, and nearly two years since the world first heard news of a novel virus in Wuhan. While the pandemic continues to shape the global outlook, markets have since rallied around a strong recovery buoyed by vaccine rollouts and government aid.

That said, even as above-average GDP growth forecasts and a strong macroeconomic backdrop give investors a solid reason for optimism, the unusual nature of the COVID recession and its subsequent recovery left distortions in the economy that contribute to some uncertainties for next year. Before diving into our outlook for 2022, I'd like to share some of the most frequently raised concerns that have come up in recent conversations with institutional consultants and financial advisors, and how Newfleet will address these concerns to generate alpha for our clients in the new year.

The dominant topic outside of COVID is unquestionably inflation; the lively debate around its transitory nature shows no signs of slowing down as prices have run hotter for longer than expected. While we ultimately believe that inflation will likely fade over the course of 2022 as supply chains regain equilibrium, several factors threaten to make inflation longer-lived, including policy missteps from global leaders, energy price volatility, and unresolved supply chain bottlenecks. In response to these market dynamics, we took advantage of investor demand for less inflation-sensitive assets by significantly increasing our allocation to bank loans, which outperformed most sectors this year.

Rising interest rates have also been a prevailing worry for fixed income investors as the Federal Reserve (Fed) weighs mounting concerns over inflation against their goal of reaching full employment and supporting the country's post-COVID recovery. Given that the Fed has remained steadfastly transparent in its messaging, we anticipate any increase in rates next year to be relatively incremental. Due to tight valuations and duration risk, our overall allocation to rate-sensitive investment grade corporate debt is now at a five-year low, making more room for opportunities we see in loans, securitized products, and high yield.

Both the European Central Bank and the Fed have made it clear that while they are slowly tightening monetary policy, their unhurried stance around rate hikes stays intact. And while global central banks are winding down their bond-buying programs, they are doing so slowly, leaving more than ample liquidity that will offset tight credit spreads. Emerging markets are a notable exception—as those regions overshoot their inflation targets, their banks are forced to hike rates prematurely before their economies have a chance to fully recover from COVID. This reinforces our historically low allocation to emerging markets.

Concerns around China also came to the forefront this year as its government initiated a regulatory crackdown across its tech and education companies. Meanwhile, signs of stress in China's debt-ridden property sector, which makes up roughly 20% of its overall economy, prompted worries of more widespread contagion. While we expect the government will ultimately be able to ring-fence the

FREQUENT CHANGES IN PERFORMANCE LEADERSHIP SUPPORTS THE BENEFIT OF DIVERSIFICATION

2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD (9/2021)	12/11-9/21 Annualized
EM Debt 18.53	High Yield 7.44	Municipals 9.05	Municipals 3.30	High Yield 17.13	EM Debt 9.32	ABS 1.77	IG Corp 14.54	IG Corp 9.89	Bank Loans 4.65	High Yield 7.44
High Yield 15.78	Bank Loans 6.15	IG Corp 7.46	MBS 1.51	EM Debt 10.19	High Yield 7.50	Municipals 1.28	EM Debt 14.42	High Yield 9.48	High Yield 3.62	EM Debt 5.48
IG Corp 9.82	CMBS 0.23	MBS 6.08	ABS 1.25	Bank Loans 9.88	Global Agg 7.40	Bank Loans 1.14	High Yield 14.32	Global Agg 9.20	Municipals 0.79	Bank Loans 5.04
CMBS 9.66	ABS -0.27	US Agg 5.97	EM Debt 1.23	IG Corp 6.11	IG Corp 6.42	MBS 0.99	US Agg 8.72	CMBS 8.10	ABS 0.23	IG Corp 4.87
Bank Loans 9.43	MBS -1.41	EM Debt 5.53	CMBS 0.97	CMBS 3.32	Municipals 5.45	CMBS 0.78	CMBS 8.29	US Agg 7.51	CMBS -0.53	CMBS 4.06
Municipals 6.78	IG Corp -1.53	CMBS 3.86	US Agg 0.55	US Agg 2.65	Bank Loans 4.25	US Agg 0.01	Bank Loans 8.17	EM Debt 5.88	MBS -0.67	Municipals 3.87
Global Agg 4.32	US Agg -2.02	High Yield 2.46	Bank Loans -0.38	Global Agg 2.09	US Agg 3.54	Global Agg -1.20	Municipals 7.54	Municipals 5.21	IG Corp -1.27	US Agg 3.01
US Agg 4.22	Municipals -2.55	Bank Loans 2.06	IG Corp -0.68	ABS 2.03	CMBS 3.35	High Yield -2.08	Global Agg 6.84	ABS 4.52	EM Debt -1.53	MBS 2.41
ABS 3.66	Global Agg -2.60	ABS 1.88	Global Agg -3.15	MBS 1.67	MBS 2.47	IG Corp -2.51	MBS 6.35	MBS 3.87	US Agg -1.55	ABS 2.13
MBS 2.59	EM Debt -6.58	Global Agg 0.59	High Yield -4.43	Municipals 0.25	ABS 1.55	EM Debt -4.61	ABS 4.53	Bank Loans 2.78	Global Agg -4.06	Global Agg 1.86

Returns in percent. As of 9/30/2021. **Past performance is not indicative of future results.** Performance of all cited indexes is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. For index definitions, please see page 10.

fallout from its property sector, valuations outside of real estate still aren't dislocated enough for us to get involved yet, justifying our minimal exposure to that country. We will continue to monitor sectors that have exposure to its markets, such as commodities.

To reiterate a point in last year's Outlook, our team is incentivized to be highly collaborative. No sector manager is compensated on the size of their allocation, and they never will be. While each sector specialist has a different responsibility, they all have the same goal: determining the proper allocation for our clients. Our track record of performance is built on the back of this collaboration, and while our allocations across sectors will be in perpetual motion, this strategy will not change.

Uncertainties aside, we are entering 2022 with a constructive view. Impressive company earnings strength, declining levels of leverage supported by open capital markets, plunging default rates projected to stay at or below 1% next year—these are just a few of the reasons supporting that view. Furthermore, investor demand for yield driven by these declining indicators of risk, negative-yielding global debt, and above-average GDP growth forecasted for 2022 bodes well for a strong technical environment.

Sectors we currently favor that will benefit from these dynamics include out-of-index/off-the-run ABS, non-agency RMBS, bank loans, and corporate high yield. These are subject to change quickly with shifting fundamentals, technicals, and valuations.

We thank you for placing your trust in us, and we wish you and your families a happy holiday season and continued health and happiness in the new year.

Executive Summary

The markets have stabilized since last year's COVID-fueled rout thanks to the great strides made by medical professionals as they worked to vaccinate the world. Thanks to vaccines, continued monetary support from the Federal Reserve, and a strong economy, we believe we are in a significantly better position today versus a year ago. Strong credit fundamentals, a positive technical environment, and a favorable macroeconomic backdrop all support our favorable outlook going into 2022.

While inflation, rising rates, and China all raise potential risks to the projected above-average GDP growth this year, we believe a nimble, multi-sector strategy able to move across the full credit spectrum universe is best positioned to take advantage of opportunities for yield while adapting to the challenges posed by these issues.

GLOBAL MACRO EXPECTATIONS FOR 2022

- Overall: Constructive.
- Meanwhile, COVID-19 and its subsequent variants continue to pose a global challenge to healthcare systems and policymakers, though vaccines have proven effective thus far. Global vaccine distribution and the resulting growth in protected populations brings us closer to containing the virus.
- China remains a risk. While we expect the government will ultimately be able to ring-fence the fallout from its property sector to prevent wider contagion, valuations outside of real estate still aren't dislocated enough for us to get involved.
- The Fed remains committed to its transparent communication strategy. Case in point: the Fed taper announcement was exactly as advertised. The reduction is intended to remain intact until mid-2022 when new purchases stop.
- The caveat here is that the taper pace can change if the FOMC deems it advisable, and when the U.S. reaches the deadline that ends new purchases, the Fed will continue to reinvest roll off.
- We expect elevated inflation readings into 2022 but anticipate those data points to prove transitory and likely to fade over the course of next year.

KEY RISKS

- Persistent supply chain disruptions.
- Policy missteps by global leaders that cause higher inflation to linger.
- Soaring heating bills this winter that worsen inflation and create economic hardship.
- The Omicron variant may cause another round of shutdowns and strain on healthcare systems.
- Distress in China's commercial real estate industry spreading to other sectors, which in turn impacts global markets.

ELEMENTS OF OUR BROAD VIEW AS WE ENTER 2022

- Newfleet expects most spread sectors to outperform U.S. Treasuries in the coming year due to their yield advantage combined with potential mild spread tightening.
- With COVID premiums now gone, we expect credit selection to be more critical compared to 2021.
- We will continue to monitor issues around supply chains, rising prices, and labor costs, though above-trend growth forecasts will be constructive for credit risk assets and low default rates support their tight valuations.
- While we have decreased our overall exposure to investment grade debt, we still see pockets of opportunity in BBBs along with banking, insurance, and REITS.
- Our allocation to emerging markets debt remains at historical lows.
- The U.S. consumer continues to be supported by low debt service, declining delinquency rates, strong jobs numbers, increasing home equity, and rising wages, pointing to a positive outlook for ABS sectors.
- Non-agency RMBS will continue to be a source of alpha as the shift toward remote work, a nationwide move to the suburbs, and millennial household formation keep future housing strength intact.
- Within municipal debt, we favor sectors with identifiable revenue streams compared to general obligation bonds. We also prefer higher quality issues as credit risk spreads trend at or near generationally narrow levels.
- While the pandemic has undoubtedly disrupted economies, the robust response from policymakers and signs of a return to normalcy are encouraging. Our multi-sector approach to fixed income investing is ideally suited for the current environment and enables us to scan the broader bond market for the most attractive investment opportunities.

—as of December 6, 2021

For the reader who would like more details on our sector outlooks, the following section provides in-depth views by Newfleet's sector specialists on their respective areas of expertise.

Spread Sector Outlook

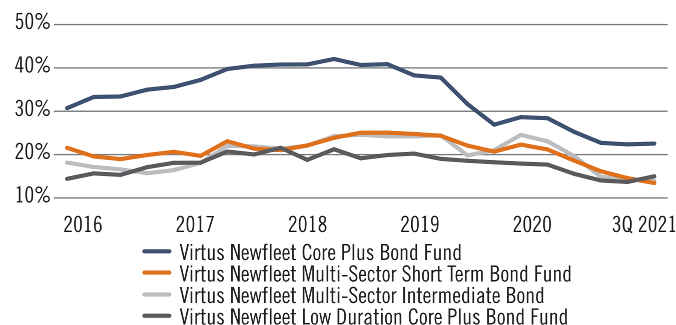
CORPORATE INVESTMENT GRADE

By Ryan Jungk, CFA

A recent Bank of America survey found that 78% of investors believe investment grade corporate debt is overvalued. While this is harshly phrased, our positioning indicates our agreement. We will enter 2022 with our lowest allocation to investment grade corporates on an aggregate basis in more than five years.

Valuations are the pain point here in an otherwise favorable outlook—we are still constructive on the fundamental and technical frameworks for the asset class. Spreads have been doing their best impression of a straight line, contained to a tight range between 80 and 90 basis points since mid-April. On a duration and ratings adjusted basis, we are approximating all-time tights as we predicted in June 2020, post-Fed intervention.

HISTORICAL ALLOCATION: IG CORPORATES



Data as of 9/30/2021

However, fundamentals are broadly encouraging. A sharper-than-expected rebound in earnings—with +45% expected for the S&P 500®—has driven debt/EBITDA leverage back below pre-COVID levels, though pre-COVID leverage admittedly started at a high point. Healthy interest coverage ratios and a record amount of subordinate capital cushion also indicate broad fundamental strength, while leverage as measured by debt/enterprise value is at a historical low as equities rallied.

Supply chain constraints pose the main risk to fundamentals, but thus far we've been impressed with the resiliency of corporate margins. Investment grade companies have an advantage here as they tend to be geographically diversified (supply chain issues are most acute in the U.S.) and larger (more bargaining power with suppliers and customers).

We expect supply needs to remain modest in 2022, in line with this year's net supply of roughly $550 billion, which comprised half of 2020's record pace when issuers established emergency war chests. Companies are sitting on elevated liquidity while the Biden administration has scuttled larger M&A deals (Aon-Willis Towers Watson, Lockheed-Aerojet) that likely discourages some leveraged transactions at the margin.

On the demand side, inflows to investment grade corporates were modestly positive all year save for some outflows in Q1 and early Q4 driven by interest rate fears. We would expect rates to continue to drive the action due to the duration sensitivity of the asset class. Foreign flows have also been positive, and on a hedged basis, the pickup from European and Japanese investment grade corporates to U.S. corporates remains attractive. Overall, we think it is likely that demand outweighs supply in 2022, which would compress spreads further.

In short, valuations are the main constraint in an otherwise positive outlook. While we have decreased our overall exposure to investment grade debt, we still see pockets of opportunity. We believe BBBs will continue to compress relative to higher rated securities, spurred by the Fed backstop and lowered fallen angel forecasts. We are also gravitating towards financial industries with strong capital levels and minimal exposure to supply chain risks such as banking, insurance, and REITS.

CORPORATE HIGH YIELD

By Eric Hess, CFA

Our 2022 outlook for high yield is favorable despite a return we project to be capped near the current 4.25% index yield. Spreads inside of long-term averages and historically low Treasury rates create a challenging environment for generating returns meaningfully above coupons.

That said, we retain a favorable view on the asset class given the supportive fundamental backdrop. This is driven by above-average economic growth, reasonable credit metrics, and a technical picture that benefits from the dearth of yield in most other fixed income segments, many of which offer negative real yields at current inflation rates.

Fundamentals in 2022 as determined by credit metrics for high yield issuers will not match the rapid pace of improvement achieved in 2021; however, current credit metrics are back to pre-COVID levels and liquidity remains elevated. We expect dispersion in financial results to increase, so aggregate credit metrics may hide volatile results from individual issuers.

Certain companies within the high yield universe could face a more challenging fundamental outlook in 2022. Relative to other fixed income markets, high yield is overexposed to smaller, less diversified firms that tend to lack pricing power in an inflationary environment and are less equipped to handle issues around complex global supply chains and volatile commodity prices.

High yield is also overexposed to energy and commodity producers whose markets are heavily linked to China. Consequently, a constant area of concern is China's slowing economic growth as several of their large property developers remain on the verge of bankruptcy. It is unclear how the government will handle that situation and what impact it will have on the broader economy.

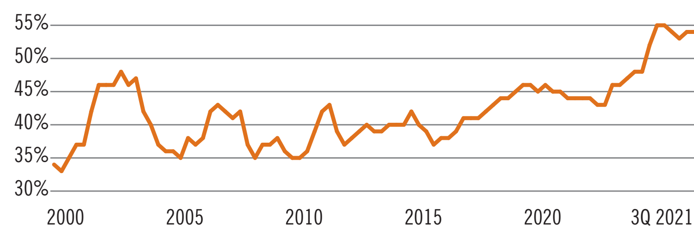
The technical picture remains neutral. Issuance for 2022 will likely stay elevated even though 2021 and 2020 already set records for total issuance. Should the current environment persist, issuers are likely to take the opportunity to refinance as a significant wave of debt becomes callable in 2022.

In addition, mergers and acquisition-related financing should increase as sponsors and companies become more aggressive after focusing on operations and balance sheets during COVID. Deals that voluntarily re-leverage balance sheets are also likely to increase as private equity sponsors already show more appetite for risk and open capital markets offer attractive terms.

While retail inflows to high yield were negative during 2021, institutional flows are likely to remain strong given the continued search for yield and lack of alternatives elsewhere. A large number of rising stars – names that move up from high yield to the investment grade index – will also likely help the overall technical picture.

Valuations have been range-bound recently with the asset class offering a 3% yield pick-up to Treasuries. High yield has traded at these levels for long periods of time, but there is little room for compression from here. The default rate has rapidly declined—now below 1% over the last 12 months—and the outlook remains benign, which supports current valuations. In addition, the quality of the high yield index is near peak levels, with BB-rated issuers making up over 50% of the index (see exhibit below) which suggests the index should trade tighter compared to prior periods.

BBs AS A PERCENT OF TOTAL HIGH YIELD INDEX



Source: Bloomberg Finance LP. Index: Bloomberg U.S. High Yield 2% Issuer Cap.

Our strategy for 2022 will be much more focused on individual names. The thematic risk-on trades that worked in 2021—including our overweight to CCC-rated bonds and COVID-exposed industries—have become less compelling.

While we still see some value in CCCs, the combination of tighter valuations, heavier supply from a rising number of LBOs and more aggressive sponsor behavior, and declining fiscal and monetary stimulus have led us to become more selective in that space. Meanwhile, COVID-exposed sectors continue to pose risks—just as COVID appears to fade, another variant drives a spike in cases. Subsequently, determining normalized returns and implied credit metrics remains a challenge when pricing the bonds of these issuers.

On the other hand, we remain generally bullish on energy- and commodity-exposed names because we think demand will remain firm due to continued economic growth supported by infrastructure spending and possible onshoring. Overall, our core fundamental analysis with a focus on finding bonds with the best risk-adjusted returns remains unchanged.

BANK LOANS

By Frank Ossino

In 2021, a low-default, improving fundamental environment was met with increasing interest rate volatility, which resulted in the loan market outperforming fixed rate sectors – YTD results illustrate this dynamic (see exhibit below). We believe we could see a continuation of this in the near and medium term.

The post-COVID price recovery has valuations currently sitting inside long-term historical averages, but in our view, this still makes long-term strategic exposure appealing based on 1.) a real income opportunity in a global low (sometimes negative) real yield environment, 2.) low correlation to traditional fixed rate investments, and 3.) compelling return per unit of risk. This thesis is especially attractive as interest rates may currently have more of an impact on total return than credit risk.

BANK LOANS VS OTHER ASSET CLASSES

As of 11/10/2021	Price	Yield to Worst	Duration to Worst (yrs)	YTD Total Return
U.S. Aggregate	105.2	1.69%	6.8	-1.53%
U.S. Treasury	102.9	1.17%	7.2	-2.48%
Investment Grade Corporates	110.6	2.24%	8.8	-0.86%
Securitized — ABS	100.8	0.93%	2.3	-0.21%
Securitized — CMBS	105.3	1.78%	5.1	-1.09%
Securitized — MBS	103.4	1.92%	4.7	-0.97%
Muni Bond	113.9	1.13%	5.1	1.14%
Emerging Market USD Aggregate	99.9	4.38%	7.1	-1.58%
U.S. High Yield	104.2	4.16%	4.0	4.89%
Bank Loans	**98.7**	**L+421**	**0.25**	**4.91%**

Loans are calculated on a 3-year discount margin basis
All indices are Bloomberg
Loan market is the S&P/LSTA Leveraged Loan Index

With loans closing the year priced near 99 cents and no signs of significant distress, total return opportunities are rare. Our next twelve-month return expectation centers around the coupon. However, we expect increased return dispersion across borrowers as idiosyncratic risks caused by current business challenges result in individual winners and losers. As the market approaches par, credit selection will become increasingly important.

Anticipated above-trend growth will be constructive for credit risk assets, with domestic GDP estimated to hit 3.9% in 2022, according to Bloomberg market consensus data. While most calls with management teams addressed supply chain bottlenecks, raw material costs, and labor shortages, borrowers have done a good job of passing price increases to consumers and realizing savings through cost reduction.

Additionally, open capital markets also allowed borrowers to refinance their balance sheets and push out scheduled maturities. We expect this favorable macroeconomic backdrop to continue going into 2022.

On the demand side, retail fund flows have been steadily positive with eleven straight months of inflows totaling over $30 billion year-to-date through October. In a rising rate environment (Fed Fund Futures point to two rate hikes starting mid-to-late 2022), we expect retail loan demand to continue.

Additionally, an attractive cost of capital, stable new issue loan spreads, and a healthy new issue opportunity set created ideal conditions for CLO creation, which has now hit a full year record at $149 billion through October—nine straight months of double-digit volume.

We suspect some of this growth may be attributed to investors and CLO managers pulling forward issuance into this year ahead of the LIBOR/SOFR transition, so we expect 2022 volume to start slowly. Still, this long-term, non-mark-to-market capital with no forced sell triggers representing over 70% of the market will continue to provide real ballast to the asset class.

Regarding new issue loan supply, investor demand was met with increased volume as management teams and private equity investors became increasingly confident in executing M&A and LBO transactions. Institutional loan issuance is up over 130% versus last year.

There are areas of concern we will remain focused on as we enter 2022. First, all eyes will be on the LIBOR/SOFR transition. We believe the loan market will successfully work through the transition in the near term but suspect both new issue supply and CLO creation will start slowly and finish the year at less than 2021's volume. Still, loan issuance should remain healthy due to continued investor demand for low duration, income-producing opportunities.

Second, several indicators point to an increase in overall loan market risk, including an increase in single B risk, an increase in covenant-lite loan volumes, and a deterioration in credit agreement documentation over time. A return to a less accommodative Fed and eventual return to on-trend (or lower) growth may result in today's incremental borrower becoming the inventory of future distress and defaults.

As we close the books on 2021, we are modeling above-trend economic growth in 2022 and will consequently look to remain fully invested going into the new year. A combination of continued monetary accommodation and companies proactively addressing balance sheets and margins point us to another low default environment. As such, we believe it is too early to position portfolios up in quality.

During the early days of COVID, we focused our analysis on company liquidity, which allowed us to then pivot to offense to take advantage of attractive total return opportunities. Since then, the COVID premium has dissipated.

We are now changing tack again. Today we are re-underwriting inflation-sensitive sectors along with credits with acute exposure to supply chain bottlenecks and labor shortages. Dollars have been redeployed into less vulnerable sectors such as technology and gaming as we navigate the impact of economic growing pains stemming from the post-pandemic reopening.

For more detail on the prospects for bank loans, see Newfleet's 2022 Bank Loan Market Update.

ASSET-BACKED SECURITIES (ABS)

By Nick Rinaldi and Zachary Szyndlar, CFA

The fundamental backdrop for the U.S. consumer remains positive going into 2022. The unemployment rate dropped to 4.60% from 6.70% at the start of the year, with strong job growth replacing stimulus payments that mostly expired this September. Meanwhile, demand for workers and a more transient workforce drove employers to increase wages, and a strong stock market has continued to buoy consumer confidence.

From a debt perspective, delinquency rates among all consumer asset types are near historical lows. Low mortgage and consumer interest rates have also reduced monthly payments for borrowers – as of today, the average consumer's monthly obligation ratio sits near an all-time low. Low interest rates are also enabling consumer finance companies to enjoy some of the lowest cost of capital funding in history, which has translated into robust bottom lines for most of these firms.

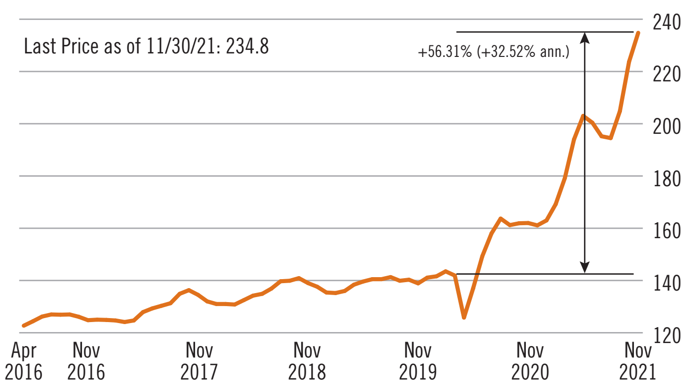
Given the current low yield and spread environment, security selection is of utmost importance and the cost of poor security selection is heightened—a fact of which we are cognizant. We continue to favor higher quality assets and are selectively purchasing subordinate bonds based on what we view as good risk-versus-return characteristics.

At the current pace of issuance, 2021's supply will surpass 2020's supply levels by 50%. Looking into the composition of that supply, we find that auto issuance historically accounts for around 50%—and this year is no different. However, we have witnessed increased issuance this year in esoteric deals such as whole business, timeshare, shipping container, and unsecured consumer loan securitizations.

Supply forecasts for 2022 call for issuance levels slightly below this year's, primarily driven by less issuance in the auto space. The fundamental backdrop for the consumer continues to improve and we expect continued positive credit performance within asset-backed securities next year.

As I mentioned above, roughly 50% of new issuance in the space comes from deals backed by auto loans. We'd be remiss not to comment on the lack of new auto supply driven by the chip shortage, which in turn has driven used car prices to record highs in 2021. Secondary vehicle valuations are important to the asset-backed market as increased recovery values on auto loan defaults ultimately flow to bondholders in the form of increased collections.

MANHEIM U.S. USED VEHICLE VALUE INDEX SHOWS USED CAR PRICES AT RECORD HIGHS



Source: Bloomberg Finance LP.

Historically, we have found attractive opportunities investing with new issuers and new asset classes in the ABS market. With ample supply and attractive funding in the securitization markets, we expect these opportunities to continue to present themselves. Unless a significant credit event occurs next year, we will repeat last year's forecast of a coupon clipping year in 2022.

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

By Nick Rinaldi, Andrew Szabo, CFA and Zachary Szyndlar, CFA

Commercial mortgage credit continued to heal in 2021 as evidenced by the 60+ delinquency rates trending lower throughout the year. Hotels and retail properties (malls) that struggled during the height of the pandemic began to turn the corner in 2021 as the economy continued to reopen.

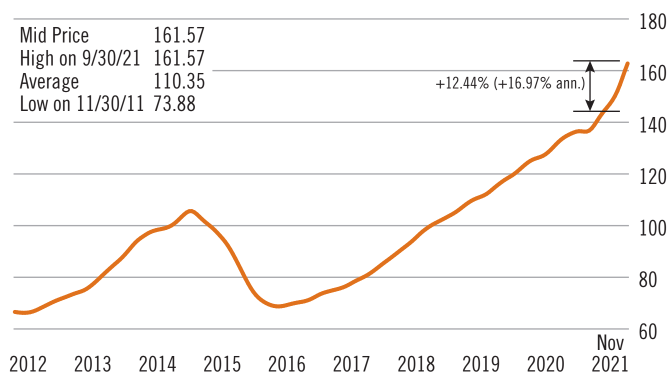
During 2021, we maintained a steady weighting to the CMBS sector. We found relative value opportunities in conduit paper with higher delinquency profiles that were still well protected from principal loss. Seasoned conduit paper traded cheaper than its on-the-run counterparts. We also added both new and secondary single-asset single-borrower (SASB) paper backed by hotel, industrial, and office properties.

Looking ahead to 2022, we will continue to search for sectors that may benefit from the continued reopening such as certain hotels, dominant regional malls, and data centers.

From a technical perspective, new issuance of private label CMBS exceeded expectations. Total private label supply will end the year at roughly 150% of last year's issuance levels. Private label supply is broken down by three categories: conduit, SASB and CRE CLO (commercial real estate collateralized loan obligation) deals. SASB transactions are usually backed by a single property or sometimes multiple properties with a single borrower. Conduit deals are backed by a pool of loans with established leases and tenants, whereas CRE CLO deals are backed by a pool of transitional assets that are actively managed.

While dissecting this year's issuance, we see SASB and CRE CLOs accounted for 80% of the overall CMBS private label issuance. Looking ahead to 2022, private label issuance is expected to grow by $10 billion and reach $160 billion, driven again by SASB and CRE CLO transactions.

REAL CAPITAL ANALYTICS NATIONAL PROPERTY INDEX SHOWS CRE PRICES UP



Source: Bloomberg Finance LP.

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)

By Andrew Szabo, CFA and Zachary Szyndlar, CFA

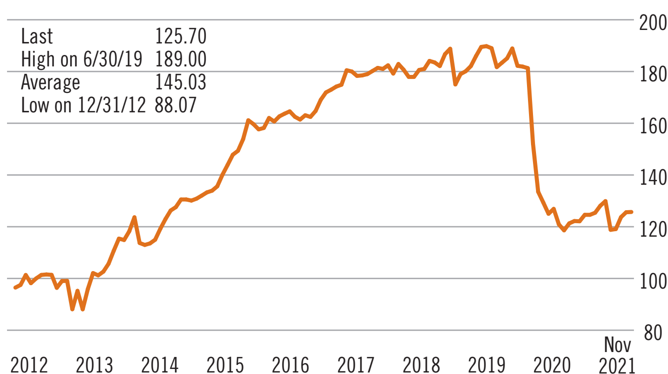
The expansion in non-agency RMBS issuance volumes continued unabated during 2021 as the market saw the largest yearly issuance since the Great Recession. With record-setting national home price appreciation and improving credit fundamentals throughout the year, we remain bullish on residential credit for the upcoming year.

Overall, we see tailwinds to spread compression from the improving employment outlook and record high home equity levels. We expect home price appreciation in 2022 to moderate but still stay positive as we continue to monitor affordability.

Even with issuance volumes increasing, we find that mortgage credit is still being prudently issued. The chart below from the Mortgage Bankers Association shows a tightening in mortgage credit brought on by the pandemic from levels that were already favorable for the RMBS investor.

Furthermore, broader secular trends such as the shift toward remote work, a nationwide move to the suburbs, and millennial household formation keep future housing strength intact. In the immediate future, the greatest limit to housing is on the supply side. Disrupted supply chains and labor shortages for home construction have been a constricting factor early into this demand cycle. However, both factors should continue to see improvement in 2022.

MORTGAGE CREDIT TIGHTENED DUE TO SHIFTS BROUGHT ON BY THE PANDEMIC



Source: Bloomberg Finance LP

With spreads for most RMBS securities at competitive levels relative to corporate bonds of comparable maturity, we expect demand for RMBS to remain firm. As we look to 2022, everything seems to point in a positive direction for housing and mortgage fundamentals, though broader macro trends could weigh on spreads.

Fortunately, the structure of securitization can help mitigate risk in a variety of ways, and RMBS will continue to be an important alpha-generating sector for Newfleet. We believe growing non-agency RMBS and residential mortgage credit markets offer some of the best opportunities in fixed income and expect the technical environment to remain constructive as the market continues to grow in 2022.

AGENCY MORTGAGE-BACKED SECURITIES (MBS)

By Andrew Szabo, CFA and Zachary Szyndlar, CFA

Despite the hype, 2021 was an uneventful year for agency MBS. However, pandemic-induced demand for housing created historically high levels of agency MBS issuance. Ultimately, this did not move the market as the Fed stuck with their massive buying program of $40 billion of MBS per month.

The market waited patiently for the inevitable taper announcement, which finally came in November to no market reaction. 2021 was defined by continued Fed purchases of MBS, stable 30-year mortgage rates, and spreads that hardly deviated from averages. With predictable prepayments and stable valuations throughout the year, agency MBS showed us again why it is one of the most efficient markets within fixed income.

As we head towards 2022, we see the potential for a more eventful year as we face many unanswered questions. Will the Fed continue to be the largest uneconomical buyer ever? Will valuations change with a smaller Fed? Are interest rates heading sharply higher? Will home price appreciation continue its blistering pace? Will we see expanded roles for Fannie and Freddie under the Biden administration's second year? Despite the questions, agency MBS valuations remain at all-time highs.

We feel residential credit is still in the middle innings of the cycle, with room for more growth. Within this sector, we believe the best investments continue to lie outside of index-eligible Fannie and Freddie MBS, and as in 2021, we will continue to focus on non-agency MBS sectors. As we identify and take advantage of the best opportunities within the securitized universe, we believe our portfolios hold alpha advantages compared with our peers.

EMERGING MARKETS & NON-U.S. DOLLAR-DENOMINATED BONDS

By Peter Lannigan, CFA, and Daniel Senecal, CFA

We continue to retain below average exposure to emerging markets (EM) debt versus our historical averages while waiting for better entry points in favor of domestic corporate credit across both investment grade (IG) and high yield (HY). A big driver of our rationale is our view that the COVID-driven global economic slowdown would hurt EM economies more than developed market (DM) economies.

In fact, this has come to pass—the growth advantage EM countries usually enjoy over DM countries of 2.0% to 3.5% vanished during the nadir of the 2020 downturn and, while we expect it to bounce back a bit, we also expect it to remain under 1% in 2022. This combined with negative real interest rates in most EMs produces a backdrop insufficient to attract enough capital inflows into EM countries to fulfill their needs. This also drives our long-held negative view on EM currencies.

The reasons center on policy flexibility. EM countries have lower access to market financing than DMs, which limits their ability to respond to economic weakness with a fiscal response sufficiently large enough to offset a large downturn in the private sector. Whether this is justified by fundamentals is open to debate. Lower income/wealth levels also make it more of a challenge for EM countries to afford vaccines while worse transportation infrastructure makes vaccine distribution harder.

Finally, lower EM central bank credibility makes it tougher for EMs to print money to buy bonds without the exercise becoming inflationary. Closely related is EM central banks' generally lower levels of credibility with financial markets. This has now forced them to hike rates prematurely (before growth recoveries are complete) to defend their currencies.

Our strategy has worked well for the past nearly two years. US corporate credit has outperformed EM in both the IG and HY tiers of credit risk. As a result, we now see relative value differentials between EM and U.S. corporate credit as fair in IG while EM is slightly cheap in the HY space. HY EM remains the spread sector where we see the most value currently.

SPREAD RATIO: EM HY VS. EM IG

Source: Bloomberg Finance LP

We expect the current neutral state of the macro backdrop to persist. At the same time, we acknowledge limited capital gain potential from those fixed income sectors that have migrated back to pre-COVID tights in spread. Rising rates cap duration gains and tight risk spreads cap spread compression gains. Our challenge has been to generate positive total return in such an environment. We seek to do this by generating "carry plus," which we define as earning the market's carry along with alpha from country and bond selection within EM.

TAX-EXEMPT MUNICIPAL BONDS

By Tim Heaney, CFA, and Lisa Leonard

Infrastructure bill talks dominated the municipal bond market this year, with much of the focus on how the bill would be paid for. With higher taxes being the anticipated solution, strong demand for tax-exempt bonds ensued. In the end, the bill did not include increased tax rates, nor did it include many of the municipal-friendly provisions that the market was hoping for because of the high costs associated with the proposals.

Even as federal tax hikes did not materialize as expected, the reasons for owning municipal bonds remain firmly in place. The expectation is that investors will remain influenced by the prospect of rising taxes, while municipal bonds' historically lower correlation to most other asset classes should provide protection and safety, especially if the economy struggles with rising interest rates or higher credit risk premiums. While 2022 may produce a positive total return, performance will likely be generated by coupon income and much less by price appreciation, especially if U.S. Treasury interest rates drift higher during the year.

Credit fundamentals also remain an important piece of municipal bond performance. If changes in credit ratings and/or outlooks were the lone indicator determining the current state of the market, one would surmise that as the COVID pandemic fades, it's full steam ahead. But while we are mostly positive on the overall state of the municipal bond market, we still recognize that the global pandemic may cause some municipal credits to struggle to find firm financial footing in a post-COVID economy.

Investors also need to be mindful as the federal aid put in place to support the economy during the pandemic phases out. The 2022 municipal bond market will likely not see a repeat of the massive tightening of credit risk spreads that it enjoyed over the previous 12+ months as the spread premiums between below investment grade-rated bonds and BBB bonds, compared to AAA rated municipal bonds, hover at historical tight levels not seen since 2007.

As these concerns present uncertainties, we continue to favor a longer-term investment strategy of higher quality issues (single A and higher), especially as credit risk spreads trend at or near generationally narrow levels. We believe that our higher quality investment strategy, distributed across multiple sectors of the market with identifiable revenue streams compared to general obligation bonds, should provide good relative performance over the long term.

For more information about Newfleet's strategies for individual and institutional investors, please visit www.virtus.com or call 800-243-4361.

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.

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The **Bloomberg Emerging Markets Hard Currency Aggregate Index** is a hard currency emerging markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The **Bloomberg Global Aggregate Index** is a broad-based measure of global investment grade fixed-rate debt investments. The **Bloomberg Municipal Bond Index** is a market capitalization-weighted index that measures the long-term tax-exempt bond market. The **Bloomberg U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The **Bloomberg U.S. Corporate Investment Grade Index** measures the performance of investment-grade corporate securities within the Bloomberg U.S. Aggregate Index. The **Bloomberg U.S. MBS Index** covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The **Bloomberg U.S. Asset Backed Securities (ABS) Index** measures ABS with the following collateral type: credit and charge card, auto, and utility loans. The **Bloomberg U.S. CMBS Index** measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300M. The **Bloomberg U.S. Corporate High Yield Bond Index** measures fixed rate non-investment grade debt securities of U.S. corporations, calculated on a total return basis. The **Bloomberg U.S. High-Yield 2% Issuer Capped Bond Index** 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 **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. The **J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified** is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging markets governments. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **S&P/LSTA Leveraged Loan Index** is a daily total return index that uses LSTA/ LPC Mark-to-Market Pricing to calculate market value change. On a real-time basis, the index tracks the current outstanding balance and spread over LIBOR for fully funded term loans. The facilities included in the Index represent a broad cross section of leveraged loans syndicated in the United States, including dollar-denominated loans to overseas issuers. **LIBOR:** London Interbank Offered Rate.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

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