2023 Fixed Income Market Outlook

Newfleet
ASSET MANAGEMENT
A Virtus Investment Partner

Dave Albrycht, CFA, President and Chief Investment Officer

2022 proved to be undeniably challenging as a confluence of events caused the worst bond market in decades. That said, my message to investors for 2023 is that value has been restored to fixed income. Forward-looking returns have not looked this attractive since the Global Financial Crisis (GFC). Yields have increased by a magnitude of 3-4x across fixed income compared to the beginning of the year—and the starting point for yields is a big contributor to long-term returns.

What caused this year's bond market rout? Post-pandemic disruptions to supply chains pushed inflation to 40-year highs, leading central banks to prioritize price stability over economic growth for the first time in 20 years. The Russian invasion of Ukraine forced the West to isolate Russia's economy, while China's growth began to slow due to its stringent zero-COVID lockdowns and its troubled property sector.

The ensuing impact worsened pre-existing bottlenecks and drove up commodity prices, further contributing to inflation. This, in turn, fueled investor worries that the Federal Reserve (Fed) would be forced to take aggressive action and risk tipping the economy into a recession. Though favorable data in the summer led some investors to hold out hope that the Fed would pivot on its monetary stance and achieve a soft landing, these hopes have not yet materialized.

These unresolved issues make economic forecasting exceedingly difficult. That said, before we expand on our outlook for 2023, I wanted to address market uncertainties that are top-of-mind right now for institutional consultants and financial advisors, and how Newfleet is positioned to make use of these uncertainties to generate strong returns for our clients in the new year.

After a year in which inflation headlines drove volatility and kept surprising to the upside, recent data shows that price pressures might finally be starting to ease. That said, we're exercising caution until more data comes out confirming the trend. It may also be premature to count on an imminent Fed pivot—it will likely take some time for the Fed to bring inflation down from current levels, so we expect rate hikes to continue for a bit longer.

Recession risk was also a significant driver of volatility as red-hot inflation and the Fed's corresponding rate hikes stoked fears that the Fed would overtighten and send the economy into a downturn. Thus far, the Fed has signaled a willingness to be flexible and responsive to new data. While recession risk has risen, we think any economic contraction will be relatively mild given companies and consumer fundamentals are starting from a position of strength. Overall, our up-in-quality positioning and credit selection across risk assets helped us generate stronger returns and avoid underperforming credits. And as inflation stayed a dominant concern throughout the year, our allocation to inflation-friendly sectors such as bank loans and securitized products also helped us outperform.

Geopolitical events also emerged as a risk this year—the West's punitive sanctions in response to the Russian invasion of Ukraine marked an unprecedented realignment of the existing world order. The war quickly took a toll on the economy, sending food and energy prices even higher. That said, our exposure to emerging markets (EM) is at historically low levels. As energy prices spiked this year, we took advantage with our overweight to commodities within high yield, which outperformed.

FREQUENT CHANGES IN PERFORMANCE LEADERSHIP SUPPORTS THE BENEFIT OF DIVERSIFICATION

2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD (9/2022)	12/12-9/22 Annualized
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 5.40	Bank Loans -3.31	High Yield 3.70
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	Global Agg 9.20	High Yield 5.26	ABS -5.06	Bank Loans 3.64
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	CMBS 8.10	Municipals 1.52	CMBS -11.81	Municipals 1.77
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	US Agg 7.51	ABS -0.34	Municipals -12.13	IG Corp 1.63
MBS -1.41	EM Debt 5.53	CMBS 0.97	CMBS 3.32	Municipals 5.45	CMBS 0.78	CMBS 8.29	High Yield 7.04	IG Corp -1.04	MBS -13.66	CMBS 1.48
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 -1.04	US Agg -14.61	ABS 1.18
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	CMBS -1.16	High Yield -14.73	US Agg 0.89
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 -1.51	IG Corp -18.72	EM Debt 0.64
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 -1.54	Global Agg -19.89	MBS 0.54
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 -4.71	EM Debt -22.24	Global Agg -0.90

Returns in percent. As of 9/30/2022. **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 12.

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We are entering 2023 with a positive outlook. Despite the headwinds I described above, there is ample room for optimism for the year ahead. The uncertain macroeconomic environment has restored value across fixed income, where yields are at attractive levels not seen in years. Overall, company earnings have shown surprising resilience in the face of inflation and rising rates. Though indicators of credit distress such as default rates, ratings downgrades, and leverage ratios are all projected to rise, they are moving off low levels relative to historical averages. The U.S. labor market has held strong despite monetary tightening, with a low unemployment rate and over 10 million job openings. And although the risk of recession has risen, we think any market decline we experience is likely to be modest.

Sectors we currently favor that we think will perform well in this environment include out-of-index/off-the-run asset-backed securities (ABS), non-agency residential mortgage-backed securities (RMBS), and investment grade corporate bonds. We also see value in higher quality corporate high yield and bank loans, with all-in yields in the 8-9% area. These are subject to change quickly with shifting fundamentals, technicals, and valuations.

As this challenging year comes to a close, we thank you for placing your trust with our team. We wish you and your families a happy holiday season and a wonderful new year.

Executive Summary

Value has been restored to fixed income. The worst bond market in decades has produced yields and forward-looking returns that have not looked this attractive since the GFC. A difficult macroeconomic environment put negative pressure on returns as markets grappled with several challenges, including the Russian war on Ukraine, inflation, recession risk, and supply chain aftereffects from COVID. Nevertheless, given resilient credit fundamentals and attractive yields not seen in a decade, we have a positive outlook going into 2023. A nimble multi-sector strategy that can spot opportunities within the full credit universe is best positioned to take advantage of these new opportunities while adapting to the challenging backdrop.

GLOBAL MACRO EXPECTATIONS FOR 2023

- Overall: Positive.
- We think China's growth will slow more than expected due to its zero-COVID lockdowns and its troubled property sector, which will impact its banking system.
- Russia's war on Ukraine will continue to impact the global economy, though Russian gas supply to Europe is already down by a significant amount. The country's nuclear tactical threat is real, though we consider it a low probability event.
- While the risk of a recession has risen, we expect the Fed to be responsive to economic data and reverse course if it overtightens. We believe if the Fed's responsiveness is effective, any economic decline we experience would likely be modest.
- We expect the Fed and other central banks to successfully restore price stability, though it may take some time for the Fed to bring inflation down to acceptable levels.

KEY RISKS

- Persistently high inflation
- Recession risk caused by Fed overtightening
- The war in Ukraine and its impact on Europe's energy prices and the world economy
- China's slowing economy/zero-COVID lockdowns impacting supply chains
- The threat of a Taiwan invasion

ELEMENTS OF OUR BROAD VIEW AS WE ENTER 2023

- We are overweight commodity-related firms as their performance benefits from both elevated commodity prices and significant efforts by their management teams to improve balance sheets.
- Within investment grade corporates, we favor BBB-rated securities for the additional carry. We are increasing our exposure to the financial sector, as its heavy supply in the market has caused a ten-year wide in spreads compared with industrials. Valuations within investment grade have greatly improved this year, and the sector is well-positioned to adapt to rising rates.
- We continue to remain underweight on EM debt, though we are now selectively adding back exposure on dips. We see more value in EM high yield than EM investment grade.
- A high number of job openings and strong wage growth help support the U.S. consumer as prices surge. Though consumer debt delinquencies are on the rise, they're coming off of all-time lows. ABS credit spreads have widened, creating opportunities to invest in high-quality assets at attractive yields.
- A challenging year brings a silver lining: fixed income sectors are now at compelling valuations not seen in years. Our multi-sector approach to fixed income investing is suited for the current environment and enables us to scan the broader bond market for the most attractive investment opportunities.

—as of December 6, 2022

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

Investment grade corporates offer good value heading into 2023. The asset class, which is coming off the worst period for total returns in modern history, offers an attractive combination of high yields, reasonable spreads, low dollar prices, and stable fundamentals. We entered 2022 with our lowest allocation to investment grade corporates in five years, but with value being restored, we have taken, and will continue to take, this allocation higher.

Valuations have greatly improved in 2022. Spreads moved from near all-time lows (duration and quality adjusted) to the top quartile of the five-year range. Yields are at decade highs —in the 6% range—while dollar prices are near 30-year lows at $87. Spreads have been choppy throughout 2022 but sit close to the halfway point between bull market levels (100 basis points) and recessionary levels (200 basis points). Given that the probability of a recession currently sits at 60%, we would not call spreads outright cheap, but when taking yields, spreads, and prices into consideration, we come away with an overall favorable stance on valuation.

If a recession materializes in 2023, fundamentals will deteriorate. However, credit metrics are starting from a very healthy position, and we are constructive on fundamentals overall. Leverage is below pre-COVID levels, while interest coverage is at a ten-year high. Investment grade bonds are well-positioned to adapt to rising rates as debt servicing costs are largely fixed, and the average time to maturity is over ten years. This means that they can pivot to a new optimal capital structure over time and will not see interest costs rise materially (maturing debt is not yet the lowest coupon vintages). These are luxuries not afforded to riskier asset classes. The list of potential fallen angels remains low, and we have not yet identified a troubled industry. This is important because prior fallen angel waves were concentrated in one corner of the market.

We anticipate a lower supply figure of roughly $1 trillion in 2023 after a resilient year for issuance in 2022 totaling $1.15 trillion. While other classes saw issuance fall by more than 70%, investment grade net supply was down just 10%. Shrinking financial balance sheets due to a slowing economy and limited M&A activity driven by volatility, high rates, recession odds, and the FTC should keep a lid on supply.

On the demand side, we experienced outflows for most of 2022, though they were modest in the context of the ugly total returns. With yields at a ten-year high and the potential for cresting inflation, we suspect investors will become more constructive on the asset class. Insurance funds, pensions, and banks are likewise to find the new yield environment conducive to more exposure. The offset is the foreign buyer —a large component of demand. In 2021, the U.S. was the only game in town, but global yields have risen off the zero bound in 2022, and hedging costs, driven by rate hikes, have decreased the attractiveness of U.S. investment grade for this base of investors. While we do not anticipate material selling pressure, we expect some level of portfolio run-off for that segment of the market.

FINANCIAL SPREAD MINUS INDUSTRIAL SPREAD

Data as of 11/16/2022. Source: Bloomberg. Index: Bloomberg U.S. Corporate Index.

Given our favorable view of fundamentals, we continue to favor BBB-rated securities for the additional carry. We are increasing our exposure to the financial sector, as its heavy supply in the market has caused a ten-year wide in spreads compared with industrials—meaning the sector is trading wider for mostly technical reasons. We are overweight commodity sectors, including energy and metals, given the dramatic improvement in balance sheets during a period of high prices.

CORPORATE HIGH YIELD

By Eric Hess, CFA

The high yield market is poised to start 2023 with a yield near 9%—an attractive level for the asset class over the past decade. However, relative value matters, and yields have risen across the bond market, with U.S. Treasuries yielding 4% and investment grade corporate bonds yielding over 5.5%. Furthermore, we view recession risk as material given the Fed continues its hawkish path to reduce inflation. Parts of the economy are already slowing due to interest rate hikes, with housing being the main example. Despite credit spreads being wide of average levels, they remain well inside of recessionary levels, so we remain cautious on the asset class.

We have an up-in-quality bias within high yield, targeting credits that avoid much of the incremental default risk incurred by lower-rated parts of the market while still offering higher excess yields over investment grade bonds. Projecting returns for the upcoming year is challenging, and we think the range of outcomes is wide given the volatility experienced

in both risk-free rates and credit spreads over the past few months. The timing of when the Fed can pause its rate hiking campaign or even cut rates again remains a key factor.

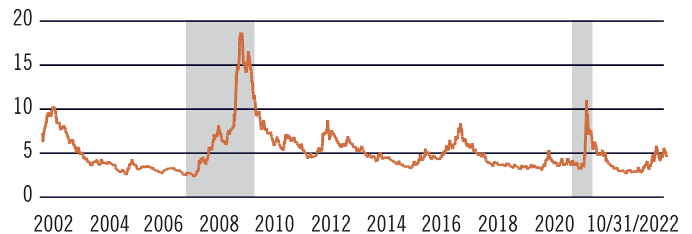
The largest meaningful counterpoint to a cautious view would be the resilience of credit fundamentals, which remain at strong levels. Aggregate leverage is below pre-COVID levels for high yield bonds, with net leverage in an even stronger position as companies hold onto cash raised during COVID. Meanwhile, shifts in the index's composition are boosting aggregate credit metrics. BB-rated issues, the highest-rated high yield bonds, have become an increasingly larger portion of the index.

However, these aggregate credit metrics can mask pockets of weakness, particularly among CCC-rated issuers. Many overleveraged issuers formerly expected to grow into their debts are now burning cash due to rising interest costs and face a weaker growth outlook as recession risks increase. Fundamentals can sometimes be a lagging indicator, and there is a risk that they will quickly deteriorate if the economy tips into recession. At the same time, starting levels do matter, and we agree that high yield is better prepared to handle economic weakness than in the past, especially in a shallower recession.

The technical environment remains neutral. 2022 saw large outflows, but very limited new issuance. Record-setting issuance years in 2020 and 2021 pushed out financing needs for most firms, with most recent issuance driven by merger activity. Economic calls—situations where an issuer can refinance bonds at a lower rate—are limited, which has also weighed on issuance. For many of the same reasons, issuance is likely to remain below average in 2023, though it will probably exceed this year's volumes—fund flows often follow returns and are difficult to forecast. Issuers moving from high yield to investment grade have helped the technical picture by reducing supply in 2022, and that trend should continue in 2023. Notably, two of the largest issuers in the high yield market, Ford and Occidental Petroleum, could potentially migrate out of the index.

Valuations look attractive relative to history, with credit spreads in the 4.5% range versus median spreads, which are closer to 3%. However, given that high yield credit spreads usually widen out to at least 8% in large selloffs, there is still more downside than upside. Implied defaults at these levels are still below long-term averages, assuming an average liquidity premium. Current default rates are still very low—less than 1% of the dollar value versus a long-term average of 3%. This metric is expected to rise in 2023, though this is not necessarily concerning given the starting level. In terms of ratings, valuations look cheapest in CCC-rated issuers—not surprising since that cohort is most vulnerable in a weakening economy. We remain highly selective in CCC-rated issuers, with the majority of exposures in less volatile industries such as healthcare, packaging, and insurance.

HIGH YIELD CREDIT SPREAD BEHAVIOR 2002–2022



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

In 2023, we will stay responsive to developments on the macro side, since data on inflation, growth, and housing will continue to play key roles in the overall direction of the market. Beyond the macro, there are many storylines across several industries that offer opportunities to generate outperformance. For example, despite recession risks and tight credit spreads, we generally remain positive on commodity-related firms as their management teams continue to improve their balance sheets. We're cautious on levered cable names as aggressive fiber buildouts by competing telecoms drive subscriber losses. We've tweaked our homebuilding and building materials exposures to be weighted more towards both higher quality credits, and commercial and renovations versus new construction, as we expect the rate environment to continue to weigh on the space. In healthcare, we expect a rebound after a challenging 2022 where elevated labor costs, lingering COVID impacts, and regulatory issues weighed on the space.

Another developing theme is the shift in value from bondholders to equity holders as private equity sponsors that own issuers with debt push for more aggressive interpretations of the issuer's credit agreements. This has made investing in more stressed companies difficult, as projected downside scenarios can move sharply lower as the collateral securing the debt is stripped. Overall, our goal remains the same: use fundamental analysis to find bonds with the best risk-adjusted returns.

BANK LOANS

By Frank Ossino

The year, which started with solid expectations for economic growth and measured Fed rate hikes, was quickly affected by the Russian invasion of Ukraine, which worsened inflation and drove market volatility. Persistently high CPI prints throughout the year have been met with aggressive rate hikes from the Fed, raising market worries around the financial health of the consumer and the ability for borrowers to service their debt.

Despite the likelihood of a negative return for 2022, loans will have outperformed all other fixed rate asset classes as the Fed's rate hikes disproportionately hurt longer-duration investments.

The current loan market valuation of +667, wider than the historical average of +526, implies that the total return opportunity for loans is approaching long-term equity return expectations. We estimate that the go-forward, risk-adjusted return profile for loans may be in the high single-digit range. For context, these valuations have only been seen in the context of recessionary periods excluding the GFC and the 2020 COVID crash, which we view as outliers.

PRICE/DISCOUNTED SPREAD MOVEMENT OF LOAN INDEX

Price/Discounted Spread Movement of CS Index Loans, December 31-November 10

	Average Price			Average DM to 3-Year		
	12/31/21	11/10/22	% Change	12/31/21	11/10/22	Bps Change
All	98.39	92.32	-6.2%	L+439	L+633	194
Liquid Loans	98.59	93.51	-5.2%	L+409	L+591	182
BB	99.42	97.52	-1.9%	L+307	L+362	55
Single B	99.15	92.72	-6.5%	L+444	L+670	226
CCC	90.61	77.18	-14.8%	L+945	L+1503	558
Defaulted	85.52	44.12	-46.5%	L+1737	L+3705	1968

Source: Credit Suisse Leveraged Loan Index. As of November 10, 2022.

The fact that loan valuations now imply returns that approach parity with long-term equity is significant, since loans may offer added benefits that equity lacks. Chief among them are low duration and seniority within the borrower's capital structure—i.e., holding assets that are first in line for repayment and recovery in case of a borrower default. These protective characteristics allow for lower levels of volatility, leading to attractive returns per unit of risk when compared to other risk assets.

LOANS AND HIGH YIELD VERSUS EQUITY MARKETS

	Annualized Return	Standard Deviation	Return Per Unit of Risk	Rolling 3-Year Periods		
				Best	Worst	% Negative
Leveraged Loans	5.26%	5.42%	1.0	17.5%	-8.0%	3%
High Yield Bonds	6.99%	8.43%	0.8	26.1%	-7.6%	7%
Large Cap Equity	9.39%	14.73%	0.6	32.8%	-16.1%	18%
Small Cap Equity	8.79%	19.26%	0.5	29.6%	-17.8%	13%

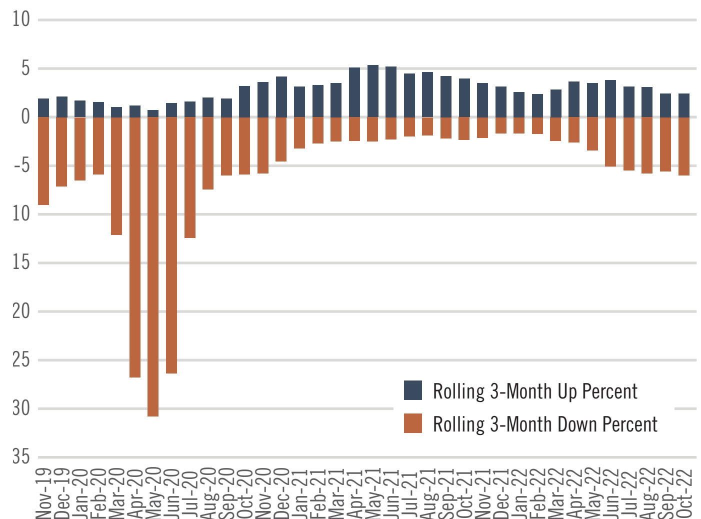
Sources: Credit Suisse, Standard & Poor's, FTSE Russell, Bloomberg. As of September 30, 2022. The High Yield, Leveraged Loan, Large Cap Equity and Small Cap Equity Markets are represented by the Bloomberg U.S. Corporate High Yield Index, Credit Suisse Leveraged Loan Index, S&P 500® Index and the Russell 2000® Index, respectively. Returns were calculated using monthly data and begin with the inception of the Credit Suisse Leveraged Loan Index on 1/1/92. **Past performance is not indicative of future results.**

That said, fundamentals now face a challenge. Domestic GDP for 2022, originally forecast to be 3.9%, is now forecast to hit below 2%, while the consensus for 2023 is now at 0.4%. These are weak numbers with little room for error. With minimal growth as the starting point, and higher and more sustained interest rates to combat inflation, the backdrop is challenging for credit risk assets.

Moreover, rolling 3-month downgrades have now exceeded upgrades since April. This has resulted in higher costs of capital, and, in some cases, limited access to capital. For context, the downgrade-upgrade ratio reached near 6:1 during the 2000-2002 recessionary period, which led to a default rate of around 6%.

The default rate decreased slightly to 0.83% in October, but with 7.1% of the loan market priced below $80 amid increasing downgrades, our view is that defaults could walk up to a 3% rate at the end of 2023—still in line with historic averages. However, over the next two years, it could reach 6%—in line with the 2000-2002 recessionary period.

ROLLING 3-MONTH UPGRADE AND DOWNGRADES

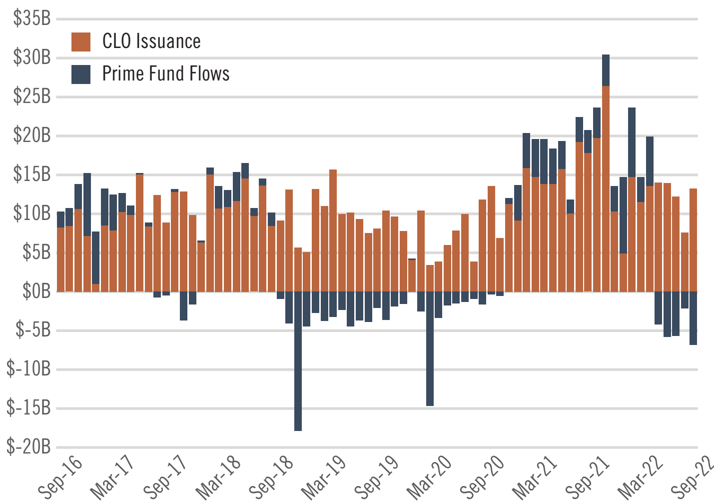


Source: Leveraged Commentary & Data (LCD); Morningstar LSTA U.S. Leveraged Loan Index. As of October 31, 2022.

The technical picture for the loan market has stayed reasonably supportive. In one of the surprise stories of the year, the collateralized loan obligation (CLO) market is on track to be a top-three year for volume, behind only 2018 and 2021. This is significant, as CLO issuance has supplied demand for loans in a year when, despite a rising rate environment, retail investors have pulled $4.4 billion out so far, YTD. As retail demand is expected to stay weak, we are also concerned that CLO issuance could slow as investors scrutinize underlying loan credit concerns.

Factors that could affect near-term volume include minimal new issue loan supply, and a lack of investor appetite for AAA-rated notes. Since CLOs represent over 70% of market demand, investor appetite for this product will need to stay resilient for the market to keep its technical balance.

INVESTOR TECHNICALS: MONTHLY EST. INSTITUTIONAL CASH FLOWS



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

Meanwhile, macro volatility and an increasing cost of capital has materially slowed new issue volume. Institutional loan issuance is down roughly 64% to $209.5 billion YTD. Volatility and wider spreads have also slowed the refinancing market. While the maturity wall remains manageable, it is critical that borrowers handle their debt balances, particularly to address the transition from LIBOR to SOFR.

We enter 2023 with no shortage of catalysts that could disrupt global economies: the impact of higher interest rates and debt service on sectors such as housing and technology, erosion of consumer demand due to stubbornly high inflation, the ongoing impact of the Russia/Ukraine war on Western European countries, and China's zero-COVID lockdowns. Tighter capital markets access could also negatively impact marginal borrowers.

One concern specific to the loan market is the persistent erosion of credit quality—the result of a decades-long low interest rate environment. Since 2010, certain credits with looser lender protections and lower credit ratings have grown to make up larger portions of the overall loan market. As we enter a potential economic downturn, these concerns will put a premium on core fundamental analysis, credit selection, and active management.

COVENANT-LITE AND SINGLE-B LOANS HAVE BECOME A LARGER PORTION OF THE MARKET

Date	Oct 2010	Oct 2015	Oct 2022
Total Outstanding ($ bil)	$509.75	$850.92	$1,424.30
Market Value Outstanding ($ bil)	$472.18	$797.16	$1,313.11
Number of Issuers	686	935	1194
% of Cov Lite Loans (at Par)	17.84%	64.02%	88.58%
Breakdown by Facility Rating (at Market Value)			
A	0.00%	0.00%	0.00%
A-	0.00%	0.00%	0.00%
BBB+	1.09%	0.00%	0.00%
BBB	1.13%	2.26%	0.29%
BBB-	3.76%	5.79%	5.25%
BB+	9.03%	9.31%	7.08%
BB	14.41%	13.12%	5.24%
BB-	16.33%	15.87%	12.65%
B+	18.76%	17.12%	12.52%
B	12.00%	21.30%	26.48%
B-	6.24%	6.48%	23.35%
CCC+	1.78%	3.81%	3.02%
CCC	2.21%	0.81%	1.57%
CCC-	0.82%	0.12%	0.23%
CC	0.43%	0.08%	0.13%
C	0.01%	0.00%	0.00%
D	3.46%	1.57%	0.33%
NR	8.53%	2.38%	1.87%

Source: Morningstar LSTA U.S. Leveraged Loan Index. As of October 31, 2022.

As of this writing, we expect a slowdown in economic growth for 2023. Thus, we will continue to re-underwrite existing positions in portfolios, focusing on the borrower's ability to service debt and its future need for capital markets access. We will keep our up-in-quality bias going into 2023 while we look for constructive data points such as economic markers, attractive technical dislocations, corporate earnings guidance, or risk-off capitulation. Any of these catalysts could result in a bottoming out and a shift in Fed priorities, which we would view as a signal to look for higher-risk opportunities.

For more detail on the prospects for bank loans, see Newfleet's 2023 Bank Loan Market Update.

ASSET-BACKED SECURITIES (ABS)

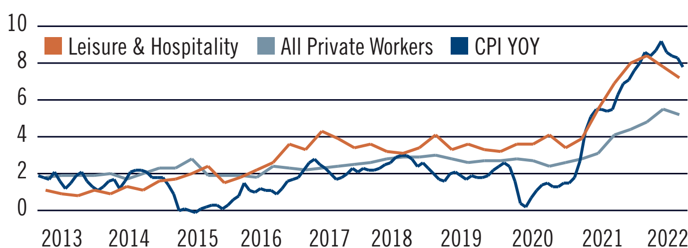
By Nick Rinaldi and Zachary Szyndlar, CFA

The securitized market has undergone a 180-degree reversal from 2021. At this point last year, we were discussing record low rates and extremely low credit spread levels. Today, credit spreads have widened for every ABS asset class, though the degree of widening varies by asset class and credit rating. In a year where most of fixed income has produced a negative return, ABS has outperformed due to its short duration and high credit quality. Amid economic uncertainty, ABS credit

spreads have widened enough to approach pre-pandemic levels, creating opportunities to invest in high-quality assets at attractive yields not seen in years.

Heading into year-end, U.S. consumer fundamentals look very solid. The job market remains constructive, with 10.7 million job openings—roughly 1.7 openings per unemployed worker. The unemployment rate dropped to 3.7% from 4.6% at the start of the year. U.S. consumers have $1.7 trillion of excess savings that enable them to manage higher inflation costs. Strong wage growth (see below) also helps offset higher inflation. Moreover, lower income quintile earners are benefiting from above-average wage growth—a trend that looks likely to continue.

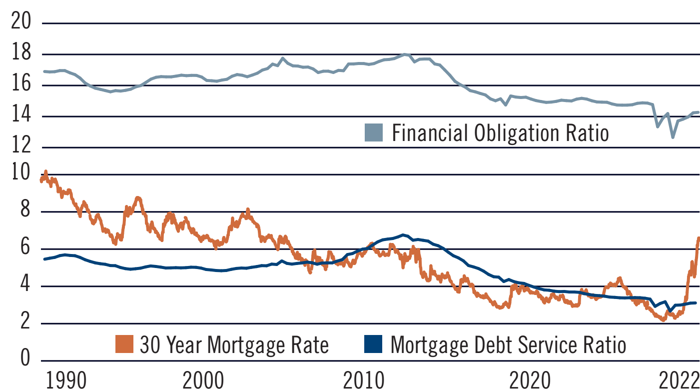
EMPLOYMENT COST INDEX



Source: Bloomberg LP, Bureau of Labor Statistics. As of October 31, 2022.

On the consumer debt side, delinquency rates are on the rise and coming off all-time lows from 2021. Delinquency rates for consumers with lower FICO ratings in particular have accelerated faster than their higher-rated peers. However, the financial obligation ratio (see exhibit below), which measures how much household income is being spent on repaying debts and other financial obligations, remains lower than historical averages. Mortgage rates have spiked, but most homeowners were able to lock in at low rates offered over the past few years, and U.S. consumer mortgage debt service is still at over 30-year lows. That said, one area worth keeping an eye on is unsecured consumer loans. This sector, which is at the lowest rung of the payment hierarchy for borrowers, has not truly been tested by a recession.

FINANCIAL OBLIGATION RATIO



Source: Bloomberg LP. November 10, 2022.

Looking at the technical picture, the velocity of the upward interest rate move coupled with spread widening has slowed the pace of issuance this year, and the higher cost of capital has kept several issuers on the sidelines. Gross issuance is expected to come in 7-10% lower than last year's levels. Issuance for 2023 will depend on whether the U.S. avoids a recession, and whether the cost of capital decreases for certain issuers.

Last year, tight spreads drove us to err on the side of up-in-quality investments and selective purchases in subordinate bonds with attractive structures and valuations. Given the dramatic spread widening this year, we are increasing our marginal dollar spend on subordinate asset classes. Even in a recessionary environment, we believe current spread entry points for certain subordinate bonds are extremely compelling. If we head into a recession in 2023, we aim to take advantage of any credit dislocations that arise as winners and losers emerge within ABS. If the U.S. Treasury curve stays range-bound in 2023 and the U.S. does not enter a deep recession, look for the ABS sector to produce a mid to high single-digit positive return.

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

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

Commercial mortgage credit stayed benign in 2022, as evidenced by the 60+ delinquency rates that stayed relatively flat for the year. Hotel property delinquency rates improved dramatically as a wide open economy powered by U.S. consumer strength drove increased demand in the leisure and hospitality space. Looking ahead to 2023, we expect delinquency rates to trend higher, driven by higher interest rates and slower economic growth.

In 2022, we kept a lower weighting to the CMBS sector, with roughly 80% of that exposure invested in the single-asset single-borrower (SASB) space. Within that, most of our SASB exposure was invested in floating rate loans, which performed extremely well in a rapidly rising rate environment as their coupons reset at those higher rates.

SASB loans are usually structured so that the issuer can exercise three one-year maturity extensions. As higher rates make refinancing difficult or unattractive for many borrowers, we expect SASB borrowers to continue to exercise these extensions in 2023. Issuers who do not refinance must either put cash into the property to refinance, or default. For the first time in a while, we may see sponsors pushing cash into deals to avoid losing properties.

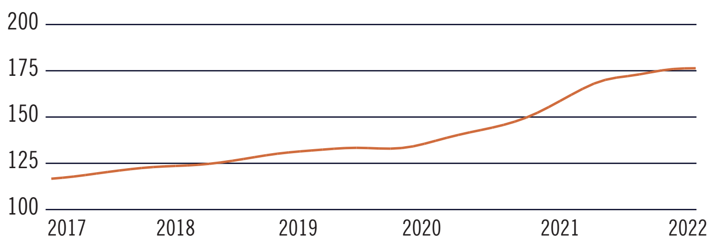
Meanwhile, commercial real estate (CRE) valuations are just starting to come off their highs. Although interest rates have moved higher, cap rates have not moved materially.

This leads us to think property valuations are misstated for certain CRE assets, and valuations may move lower as a result. One sign of this is the extreme spread widening in the levered portions of the conduit loan capital stack.

The sharp rise in rates and broader uncertainty in the commercial real estate market has slowed new issuance levels dramatically within private label CMBS. We expect this year's issuance to approach approximately 65% of last year's levels. Private label supply is broken down by three categories: conduit, SASB, and CRE CLO 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, while CRE CLO deals are backed by a pool of transitional assets that are actively managed.

For 2023, look for spreads to remain wide in this asset class, driven by higher rates and the possibility of an impending recession.

REAL CAPITAL ANALYTICS COMMERCIAL PROPERTY PRICE INDEX



Source: Bloomberg Finance LP. September 30, 2022.

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)

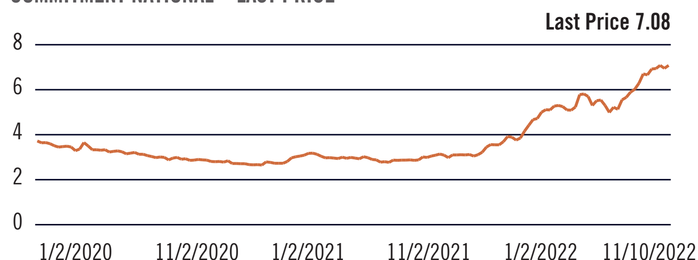
By Andrew Szabo, CFA, and Zachary Szyndlar, CFA

2022 was a challenging year for the non-agency RMBS market. In a short period of time, mortgage rates more than doubled from all-time lows to 20-year highs. In addition to macro uncertainties and rising rates, this market struggled with ballooning extension risk and slowing prepayment speeds—both detrimental to performance in a rising rate environment. Lastly, the healthy expansion of the non-agency RMBS market in 2021 continued in 2022 but was met with less demand. The market had to digest the highest levels of positive net issuance since the GFC, putting further pressure on spreads.

Heading into 2023, the supply technical will turn positive, and extension risks are close to fully priced in. The next obstacle facing non-agency RMBS will be housing price declines in the U.S. The latest reports from the home price indices showed the first month-over-month declines in nearly four years. With housing affordability near all-time lows, housing prices are expected to fall anywhere from 0% to -10%. However, a chronic lack of housing supply and tight inventories will bolster these price declines.

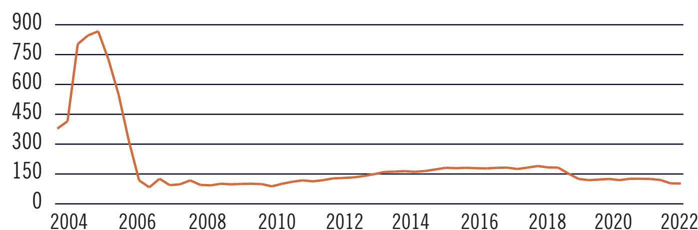
The chart below from the Mortgage Bankers Association shows a tight credit environment, which augurs for good credit performance going forward. Because lending standards and loan products have stayed more conservative, this cycle is very different compared with the GFC. In fact, during the roughly 40% run-up in home prices since March 2020, lending standards have tightened, and most loans are simple 30-year fixed rate loans. In contrast, home price increases in the early 2000s were fueled by loosening lending standards and "innovative" loan products.

FREDDIE MAC U.S. MORTGAGE MARKET SURVEY – 30-YEAR HOMEOWNER COMMITMENT NATIONAL – LAST PRICE



Source: Bloomberg Finance LP. November 10, 2022.

MORTGAGE CREDIT AVAILABILITY INDEX TOTAL – MORTGAGE BANKERS ASSOCIATION



Source: Mortgage Bankers Association. As of October 31, 2022.

With spreads for most RMBS securities at competitive levels compared against agency MBS and corporate bonds of comparable maturity, we expect demand for RMBS to improve. As we look ahead, valuations will depend more on broader macro trends—prices in the sector already take the widely known negative housing data into account. The robust fundamentals, structures, and broad opportunity set available in the non-agency market may ultimately provide attractive investment opportunities in 2023.

AGENCY MORTGAGE-BACKED SECURITIES (MBS)

By Andrew Szabo, CFA, and Zachary Szyndlar, CFA

Agency MBS had an eventful year as well—the sector experienced rapidly increasing mortgage rates leading to the longest durations ever, elevated interest rate volatility, and the exit of the largest buyer (the Fed). All these factors have sent MBS valuations to some of their cheapest levels in a long time.

The supply technicals of the market should become a positive in 2023 as higher rates slow housing activity to a crawl. Without any credit concerns in the sector, agency MBS may benefit compared with other sectors whose performance will be more sensitive to macro events and a possible economic slowdown.

Along with supply, the demand side should improve once volatility stabilizes. Money managers were absent much of 2022 due to fund redemptions. Their return to the MBS market will be key to performance. Prepayment speed uncertainty is no longer a factor, as borrowers are well out of the money to rate-refinance. Because of this, MBS now has some of the best convexity ever.

In 2023, we see the potential for a recovery in spreads as the agency MBS market trades at a large discount to par. Residential credit is still in the middle innings of the cycle, with room for more growth, and long-term structural tailwinds. Within the residential mortgage sector, we believe the best investments continue to lie outside index-eligible Fannie and Freddie MBS, and we will continue to focus on the non-agency MBS market. As we identify the best opportunities within the securitized universe, we believe our portfolios have the ability to offer alpha advantages compared with our peers.

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

By Peter Lannigan, CFA, and Daniel Senecal, CFA

Emerging markets (EM) had a challenging year, with YTD returns of -23.83%—thus far exceeding the worst year ever for EM debt. A host of negative macro developments contributed to underperformance, including inflation, the war in Ukraine, and hawkish global central banks. In a nutshell, central bank tightening at a time of slowing global growth produced the worst performance in the broader bond market since 1949.

This resulted in a rare combination of both higher government bond yields and wider credit risk spreads. Tighter Fed policy brought the U.S. Treasury 2-year yield to maturity to close to 5% from less than 0.5% about one year ago. This, plus credit risk spread widening across the board, pushed EMD lower. Consequently, our exposures to the asset class were at or close to all-time lows for most of 2022.

However, while we remain cautious on the asset class due to these concerns, we now see more value after record underperformance. The recent drawdown was far more severe than prior periods of distress, which includes the 2008 GFC, the 1998 Russian currency crisis, and the 1994 Mexican peso crisis, when the EMD market declined by 10.9%%, 11.5% and 18.3%, respectively. The severity of this year's poor performance was not due to any event particular to EM, but rather an overall deterioration in macro conditions.

In late summer, more attractive yields prompted us to start adding exposure. Our views on key risks are now more balanced, and we think EM bond prices already incorporate news around high inflation and weak growth. Plus, market sentiment is still bearish. All of this is reflected in a yield of 8.3%, which is near its post-GFC high.

Because we expect inflation to take some time to subside, we do not expect U.S. rates to rally much, if at all. However, we are starting to see light at the end of the tunnel, given how much monetary tightening the economy has already undergone. Outside of the world's largest economy, the impact of other key global variables are well known and already priced into securities.

China's growth has slowed, mainly caused by its zero-COVID restrictions, the ultimate clean-up costs of the distressed real estate market, and its impact on the banking system's loan quality. By extension, we will closely monitor the resulting impact on China's fiscal accounts and debt servicing capability. Meanwhile, Russia remains a geopolitical wild card. However, we think most of its potential impact on European growth is already known, as reflected by Russian gas supply to Europe being reduced by 80%.

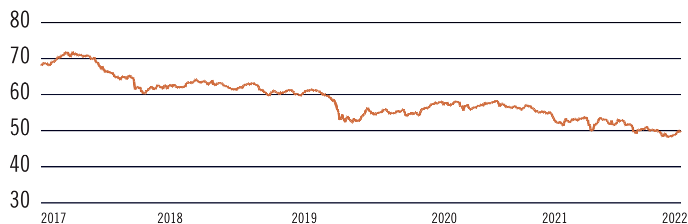
Within U.S. dollar denominated EMD, we continue to see much greater value in high yield than in investment grade. This is reflected in our two-thirds high yield to one-third investment grade credit quality mix, which is the opposite of the market's credit quality mix of two-thirds investment grade to one-third high yield.

EM HY SPREADS

Source: Bloomberg Finance LP. As of November 16, 2022.

We have held no exposure to local currency EMD for the past few years. Note that our strong view on the U.S. dollar has occurred despite commodity price strength, thus upending the long-term inverse relationship between the two. This has lowered the volatility of our multi-sector portfolio holdings significantly. However, every EM financial asset has a price. Thus, we are now scrutinizing this underperforming space for potential opportunities.

EM CURRENCY INDEX



Source: Bloomberg LP. Index: J.P. Morgan Emerging Markets Currency Index.
As of November 16, 2022.

Higher rates and below-average credit risk spreads have suppressed capital gains from fixed income assets—rising rates cap duration gains, and tight risk spreads cap spread compression gains. Our challenge, which we have been meeting, is to generate positive total returns in an environment that has produced range-bound interest rates and credit risk spreads.

Tactically, we are still not chasing rallies, though we are starting to increase exposures on dips. While we are adopting a more positive risk asset directional bias, we also do not see the price path as a straight line up. We are picking our entry points carefully. We aim to earn positive total return by looking for "carry plus," which we define as obtaining the market's carry, augmented by alpha from sector selection and, within EM, country and bond selection.

TAX-EXEMPT MUNICIPAL BONDS

By Ron Schwartz, CFA, and Dusty Self

Municipal bonds will be attractive in 2023, fueled by strong investor demand and constrained supply. Absolute rates are at decade highs and credit fundamentals remain stable, bolstered by historic levels of revenue collections, rising property valuations, and budget surpluses. Municipal supply is likely to remain modest until interest rates stabilize, creating a favorable imbalance in the supply-demand dynamic. Furthermore, municipals continue to benefit from a lack of correlation to other asset classes, while defaults continue to be rare and well telegraphed.

State and local governments started fiscal 2022 with record levels of reserves, giving the credits significant flexibility and ability to weather periods of volatility. This was largely attributable to large infusions of federal relief aid, robust property tax assessed valuations, and better-than-expected sales and income tax collections. However, these same ballasts of credit stability could turn into headwinds in 2023 should an economic slowdown or inflation take hold. After widening for much of the year, credit spreads recovered in late 2022, with some nearing their 10-year averages. For example, the one-year average spread on a 10-year Texas General Obligation bond is 11 basis points, while its 10-year average is 12 basis points. Similarly, the one-year average spread between a 10-year AAA-rated bond and 10-year BBB-rated bond is 80 basis points; the 10-year average spread is 96 basis points.

Municipal supply for 2023 should be relatively flat versus fiscal 2022, with projections for new issuance ranging from $380 billion to $420 billion for the year. Given the current high interest rate environment, many issuers may choose to fund capital needs from balance sheet cash rather than accessing the new issue market. Similarly, high rates will dampen refunding issuance and render some projects economically unfeasible.

While valuations, spreads, and credit fundamentals are providing strong underpinnings for the municipal market, the uncertainty of rates continues to be a cloud over the municipal investor. Given this, we can expect mixed inflows and outflows for 2023. We continue to favor a longer-term investment strategy of higher-quality issues (single A or higher). We believe that our higher-quality investment strategy, distributed across multiple sectors, including those with identifiable and recession-proof revenue streams, should provide good relative performance over the longer 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.

IMPORTANT RISK CONSIDERATIONS: Credit & Interest: Debt instruments are subject to various risks, including credit and interest rate risk. The issuer of a debt security may fail to make interest and/or principal payments. Values of debt instruments may rise or fall in response to changes in interest rates, and this risk may be enhanced with longer-term maturities. **High Yield Fixed Income Securities:** There is a greater risk of issuer default, less liquidity, and increased price volatility related to high yield securities than investment grade securities. **ABS/MBS:** Changes in interest rates can cause both extension and prepayment risks for asset- and mortgage-backed securities. These securities are also subject to risks associated with the non-repayment of underlying collateral, including losses to the fund. **Foreign & Emerging Markets:** Investing in foreign securities, especially In emerging markets, subjects the fund to additional risks such as increased volatility, currency fluctuations, less liquidity, and political, regulatory, economic, and market risk. **Municipal Market:** Events negatively impacting a municipality, municipal security, or the municipal bond market in general, may cause the fund to decrease in value. **Bank Loans:** Loans may be unsecured or not fully collateralized, may be subject to restrictions on resale and/or trade infrequently on the secondary market. Loans are subject to credit and call risk, may be difficult to value, and have longer settlement times than other investments, which can make loans relatively illiquid at times. **Market Volatility:** Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could have a significant impact on the portfolio and its investments, including hampering the ability of the portfolio manager(s) to invest the portfolio's assets as intended.

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 **Morningstar LSTA U.S. 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. **SOFR:** The Secured Overnight Financing 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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