April 2021

Securitized Credit – Short on Duration, Long on Relative Value

Newfleet ASSET MANAGEMENT

A Virtus Investment Partner

When focusing on the short end of the yield curve, both historically and today, securitized credit offers a yield advantage relative to comparably rated bonds. As a component of an investor's portfolio, securitized credit provides diversification from corporate bonds through direct exposure to the U.S. consumer who accounts for 70% of all economic activity. The strength of the consumer and pent up demand in the current environment is well-documented. As a result of the massive stimulus packages in response to the COVID-19 pandemic, household savings have increased rapidly while debt service ratios have reached record lows. Further, historically low mortgage rates continue to create strong demand for residential real estate. The relative value of securitized assets to corporate investment grade bonds is evident in the latter's lower yields and approximate duration of 8.5 years. With inflation fears and interest rate risk hanging over financial markets, the rationale for short-duration securitized credit is compelling especially when considering the lack of yield opportunities in this environment.

THE SECURITIZED CREDIT MARKET – KEY ATTRIBUTES

- Securitized credit represents a large and differentiated asset class of debt securities backed by a broad array of asset types. Asset-backed securities (ABS – including auto loans, equipment leases, franchise receivables, credit card receivables, and student loans) and mortgage-backed securities (MBS – pools of mortgages, including both residential/commercial and agency/non agency) provide a wide investment opportunity set and diversification relative to traditional fixed income. This expanded investment universe, which includes smaller niche markets, provides opportunities to add value through attractive yield alternatives and price inefficiencies.

- To put the securitized credit market and its opportunities into perspective, outstanding securitized products currently represent over $13 trillion in a near $51 trillion U.S. fixed income universe. The Bloomberg Barclays U.S. Aggregate Bond Index (Aggregate Bond Index), consisting mostly of agency MBS, does not include a large portion of non-traditional securitized assets, suggesting that the latter are underrepresented in the more index-oriented institutional investors' portfolios. Nearly 48% of securitized debt, or roughly $6.3 trillion of the $13 trillion, is out-of-index.

- Securitized credit can be structured with either a fixed or floating coupon. Issuance of ABS and non-agency residential mortgage-backed securities (RMBS) over the past several years has averaged approximately 14% floating rate. For the Single Asset Single Borrower subsector of commercial mortgage-backed securities (CMBS), the percentage of floating rate issuance has been well over 60%. This dynamic (fixed or floating) provides an additional opportunity to manage duration/interest rate sensitivity.

- Analysis of a securitization involves both an evaluation of the underlying collateral and deal structure, such as seniority/cash flow prioritization and relative value within the capital stack. Both features can positively or negatively impact potential return and risk. This added complexity requires extensive experience and skill to successfully invest in securitized credit.

ATTRACTIVENESS OF SECURITIZED CREDIT – FUNDAMENTALS, TECHNICALS, VALUATIONS

The determination of relative value is a function of fundamentals, technical factors, and valuations, which Newfleet assesses within and between sectors and summarizes in our monthly "heat map" (exhibit at bottom of page).

Securitized product stands out:

- The fundamental backdrop is highly supportive of securitized credit for a variety of reasons. First, the latest round of stimulus, the American Rescue Plan Act (ARPA), was signed into law on March 11 with a value of $1.9 trillion. If history is a guide, the vast majority of new stimulus will go toward savings, paying down debt, and investing. Second, the unemployment rate has trended lower (6% as of March), as well as continuing jobless claims albeit at a slower pace. Third, the Federal Reserve's ongoing purchases of MBS has kept yields and mortgage rates near all-time lows, providing a boon to the housing market. These factors are clearly bullish for the consumer and real estate, which strengthens the underlying collateral (and supports new issuance) of RMBS and various sub-sectors of ABS.

  In addition, historically, rating agencies require a higher level of credit support within securitized transactions post a market dislocation. This period is no exception as we are witnessing increased credit enhancement levels (i.e., additional collateral), which further protects investors.

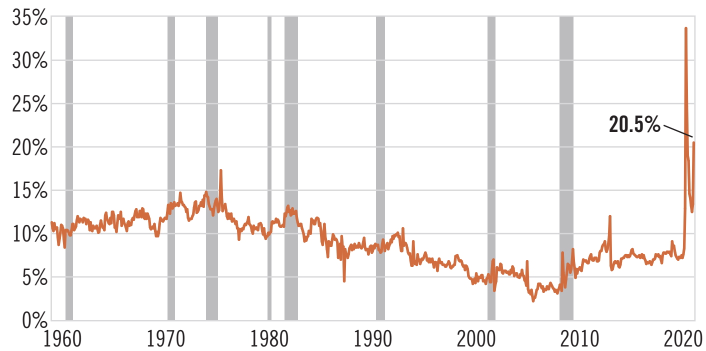
- The technical (supply/demand) environment for securitized assets remains strong – particularly for ABS, non-agency RMBS, and CMBS – with robust demand continuing to overwhelm supply. Thus far, fund flows have dominated the front part of the yield curve reflecting a tremendous demand for short-duration assets. With interest rates on the longer end of the curve near historical lows, we envision this trend will continue.

- From a valuation standpoint, yields are at record lows, but spreads that are available in the securitized arena are still attractive versus comparable-duration corporate and risk-free assets.

FUNDAMENTALS – UNPARALLELED STRENGTH OF THE U.S. CONSUMER

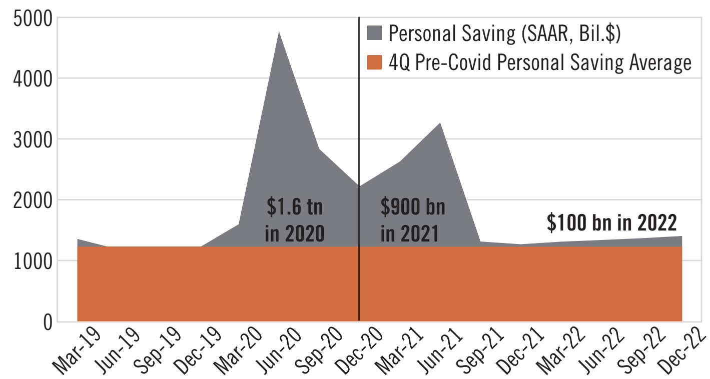
The U.S. saving rate as a percentage of disposable income was 20.5% as of January 2021, having reached a record high of 33.7% in April 2020. In the second exhibit below, Morgan Stanley estimates that the relief packages in the aggregate will result in nearly $1 trillion in "excess savings" in 2021 relative to pre-pandemic levels.

PERSONAL SAVING RATE



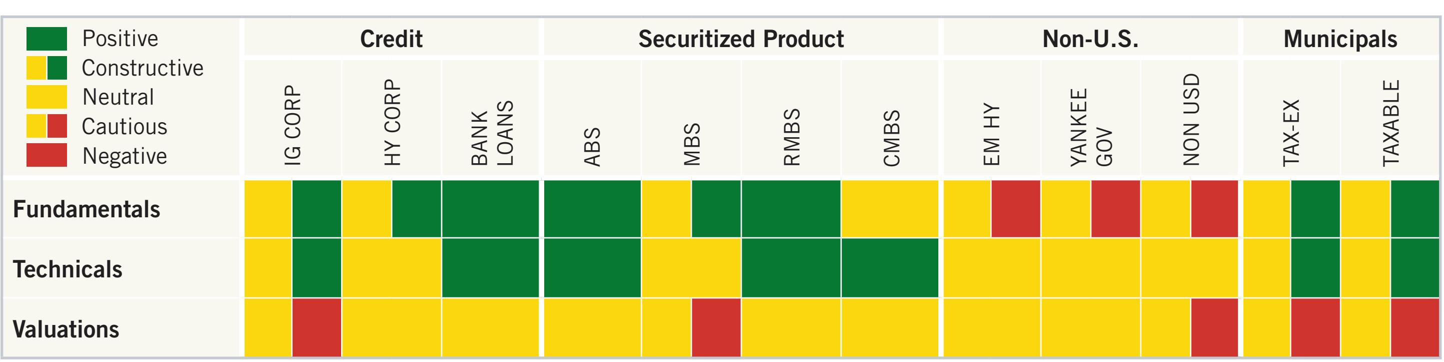
U.S. recessions are shaded; the most recent end date is undecided. U.S. Bureau of Economic Analysis, Personal Saving Rate, retrieved from FRED, Federal Reserve Bank of St. Louis.

EXCESS SAVINGS



Source: BEA, Morgan Stanley Research

SECTOR ASSESSMENTS

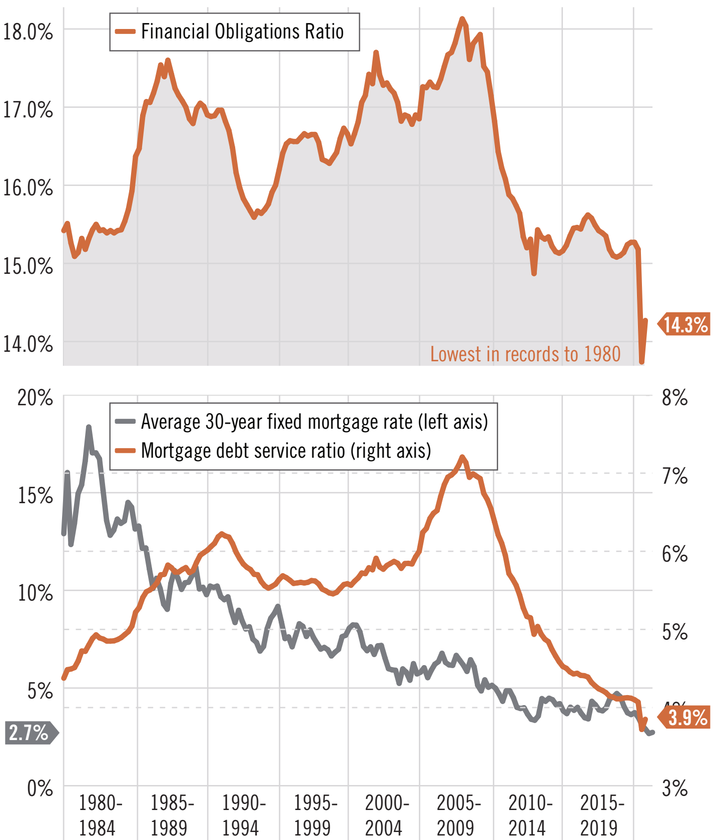


Newfleet's assessments of non-government spread sectors as of March 31, 2021.

Taking the impact one step further, *The Economist* (March 13, 2021) estimates that excess savings in the U.S. may exceed 10% of GDP as President Biden's $1.9 trillion stimulus package filters through the economy.

The combination of a high level of savings with record low interest rates have allowed consumers to have the lowest debt-service coverage ratios in the last 30 years.

CONSUMER DEBT SERVICE RATIOS

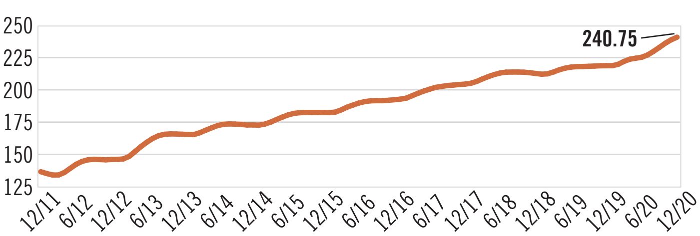


Mortgage rate data as of 1/28/21; all other data as of 9/30/20. Source: Bloomberg L.P.

FUNDAMENTALS – HOUSING MARKET "ON FIRE"

Historically low mortgage rates and limited housing inventory have created a situation of demand far exceeding supply and accelerating home prices. The exhibit below demonstrates the strength of the housing market even during the pandemic. The latest report shows a 10% year-over-year gain in the Case-Shiller Index in December 2020.

S&P CORELOGIC CASE-SHILLER 20 CITY INDEX

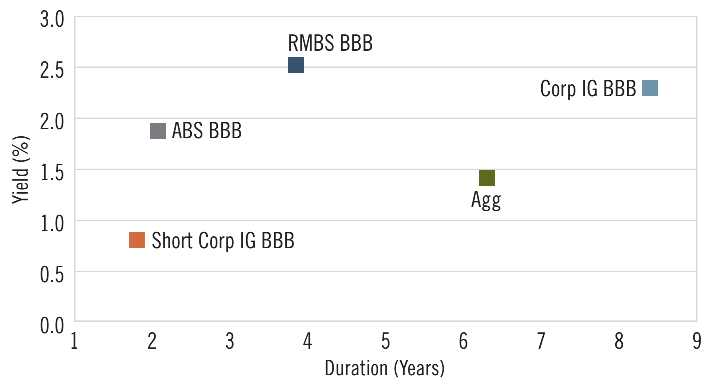


Data as of 12/31/20. Source: Bloomberg L.P.

In the RMBS sector, mortgage credit (delinquencies) are continuing to improve. In April 2020, over 80% of 30-day delinquencies were in forbearance. That has fallen to less than 40% of 30-day delinquencies currently. Mortgage credit availability continues to be tight, remaining at its lowest level since 2014. Strong underwriting today will lead to better credit performance in the future.

VALUATIONS – HIGHER YIELD WITH LESS RISK

As the exhibit below indicates, the relative value of securitized credit is evident in comparison with corporate investment grade securities. With a substantially longer duration, BBB rated IG securities yield less than similarly rated RMBS and only slightly more than their ABS counterparts.



Past performance is not indicative of future results.
As of 2/28/21. Corporate data: Bloomberg Barclays Aggregate Bond Index and ICE BofA 1-3 Year A-BBB US Corporate Index. ABS and RMBS data: based on firmwide exposures across Newfleet Asset Management. Yield shown is yield to worst.

RISING RATES AND THE THREAT OF INFLATION

Concerns over inflation have resulted in a 10-year U.S. Treasury yield that has risen to an elevated yield above 1.70%, as of this writing, and a steepening yield curve. The potential impact of ARPA, effective vaccine rollouts, improving COVID-19 case numbers, and continued business reopenings are all fueling the concerns, alongside GDP growth expectations close to 6%. The U.S. five-year breakeven rate is roughly 2.5%.

We share a view that sustained inflation is not an issue in the near term, though we do expect that rates will move gradually higher. An allocation to short-duration assets is an effective hedge against rising interest rates, allowing quick repayments of principal that can be reinvested at higher rates.

CONCLUSION

Securitized credit is an integral part of the U.S. fixed income universe, which is not fully captured within traditional fixed income benchmarks. Securitized credit is particularly attractive currently and likely to remain so for the foreseeable future. Fundamentals, technical conditions, and relative valuations are favorable in today's market environment. Considering fundamentals, a strong U.S. consumer with pent-up demand is likely to continue to power the economy against a backdrop of improving unemployment levels and jobless claims, while an accommodative Fed supports a booming housing market. Technical conditions remain strong as robust demand for shorter-duration assets relentlessly outpaces supply. In terms of relative valuation, with inflation concerns and rising rates on investors' minds, the rationale for short-duration assets is compelling particularly given the relative higher yields with similar-to-higher credit quality versus comparable investment grade bonds.

WHY NEWFLEET

Maximizing the potential benefits from securitized credit requires a skilled and experienced investment manager with a proven ability to identify and act on opportunities. Within the sectors, our size, experience, industry relationships, multi-sector relative value approach, and hands-on trading provide the advantages that underlie our performance and differentiate us from our peers.

Newfleet is well positioned to take advantage of opportunities in the securitized credit market, particularly in smaller deals or newer products that can have a measurable impact on performance. Given the strength in fundamentals of the U.S. consumer and housing, as outlined above, we have a significant overweight to out-of-index ABS and non-agency RMBS (the non-traditional securitized assets underrepresented in the Aggregate Bond Index). Some examples of smaller niche sectors that we invest in are: subprime auto, unsecured consumer loans (peer-to-peer), equipment leases, royalty fees, timeshares, non-performing loans, and single-family rentals. Depending on specific client needs and preferences, an allocation to securitized credit may be appropriate on either a stand-alone basis or in a multi-sector portfolio structure.

SECURITIZED PRODUCT TEAM

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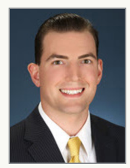

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The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. The **Bloomberg Barclays U.S. Corporate Bond Index** is a component of the U.S. Aggregate Bond Index. It measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers. The **ICE BofA 1-3 Year A-BBB US Corporate Index** measures performance of U.S. corporate bond issues rated A through BBB, inclusive (based on an average of Moody's, S&P and Fitch), with a remaining term to final maturity less than 3 years. The index is calculated on a total return basis. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment.

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 portfolio. **Foreign & Emerging Markets:** Investing in foreign securities, especially in emerging markets, subjects the portfolio 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 portfolio 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.

Newfleet Asset Management's industry trends and observations are the result of research conducted by the portfolio management / research team. These observations reflect their industry expertise and have been prepared using sources of information generally believed to be reliable; however, their accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice. Investing is subject to risk, including the risk of possible loss of principal.

Past performance is not indicative of future results.