NEWFLEET ASSET MANAGEMENT

Fixed Income Sector Review

As of September 30, 2021

OBSERVATIONS ON THE MACRO ENVIRONMENT & MARKET CONDITIONS

- Last month we noted that while we still saw the global macro backdrop as neutral, we were compelled to discuss growing odds of a less favorable backdrop developing.
- We did not expect it to deteriorate so quickly. Since the beginning of September, the S&P 500 has lost about 5% of its value and the 10-year US Treasury yield has increased by about 20 bps. While this is not a major risk event-driven sell-off like the COVID lockdown, it is likely enough to induce many to reconsider the goldilocks scenario for developed country equities – i.e., sufficient growth to support stretched equity valuations, but not so much as to push low interest rates meaningfully higher.
- Our strategy remains to earn the carry from fixed income assets as rates and risk spreads remain in roughly well-defined ranges – albeit still on the tight side of those ranges even after the recent disruption. This last point is why we tactically reduced our overall exposure to credit sensitive bonds leading into the recent bout of de-risking. However, we are still not re-entering our riskier positions.
- The key driver remains China and commodity-driven inflation.
    - We still do not have any exposure to China because we think growth estimates are overly optimistic in the face of the government's pursuit of its regulatory crackdown, which could spread to other industries beyond the real estate sector – the banks in particular.
    - The sharp rise in energy commodities and some base metal prices this year is impressive. However, we do not expect this to translate into broader price pressures as much of the price gains emanate from supply disruptions.
- As a result, we are holding our year-end rate forecast to the mid 1% range, which represents a slight reduction from our previously long-held view of a high 1% range.
- Overall, we still do not anticipate a recession, because government policy makers remain on high alert and developed country inflation remains well contained.

SECTOR ASSESSMENTS

Legend: Positive / Constructive / Neutral / Cautious / Negative

	Credit			Securitized Product				Non-U.S.			Municipals	
	IG CORP	HY CORP	BANK LOANS	ABS	MBS	RMBS	CMBS	EM HY	YANKEE GOV	NON-USD	TAX-EX	TAXABLE
Fundamentals	Constructive	Constructive	Positive	Positive	Constructive	Positive	Neutral	Cautious	Cautious	Cautious	Positive	Positive
Technicals	Constructive	Neutral	Constructive	Positive	Neutral	Positive	Constructive	Neutral	Neutral	Neutral	Positive	Positive
Valuations	Cautious	Cautious	Cautious	Neutral	Cautious	Neutral	Neutral	Neutral	Cautious	Neutral	Cautious	Cautious

Newfleet's assessments of non-government spread sectors as of September 30, 2021. Assessments are determined by analyzing a sector's fundamental data, technical indicators, and relative valuations. Sectors (l to r): **Credit**: Investment Grade (IG) Corporate Bonds, High Yield (HY) Corporate Bonds, Bank Loans. **Securitized Product**: Asset-Backed Securities (ABS), Agency Mortgage-Backed Securities (MBS), Non-Agency Residential MBS (RMBS), Non-Agency Commercial MBS (CMBS). **Non-U.S.**: Emerging Markets HY, Yankee Government, Non-U.S. Dollar. **Municipals**: Tax-Exempt, Taxable.

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.

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SELECT SECTOR HIGHLIGHTS

Sector	Highlights
Investment Grade Corporate Bonds	• It was the status quo for much of September: steady demand, manageable net supply, stable fundamentals, and sideways spreads. As the month ended, rates jumped, supply chain and China property sector risks came to the forefront, and earnings estimates began declining. While this wobble could prove transitory, it is difficult to be bullish on a long duration asset class with spreads near 15-year lows. • The market saw gross and net supply of $184 billion and $79 billion, respectively, both in-line with expectations and the five-year average. Supply skewed heavily towards financials (56% of net supply vs 10-year average of 27%) and BBB issuers (54% of net supply vs 44% average). • The compression theme is evident in the year-to-date period, with BBBs trading 36 bps wide of A-rated credit, versus a five-year average of 58 bps. This is a new post-crisis low.
High Yield Corporate Bonds	• Fundamentals still look strong for issuers as default rates continue to fall (1.65% LTM as of end of September vs 1.90% in August) and upgrade-to-downgrade ratios continue to improve (YTD ratio of 2.3 as of September vs 0.3 in 2020). While third quarter earnings should drive further improvement in credit metrics, investors will be focused on companies' ability to overcome rising prices, deal with any supply chain disruptions, and secure adequate labor. • Leading into September, investors raised cash for a primary market that was advertised to be one of the most active of the year. However, the new issue calendar underwhelmed, prompting the investor community to invest in the secondary market supporting valuations. The large increase in new issuance after a seasonally slow August led to a $12 billion supply surplus despite positive retail inflows. • Amid a surge in US Treasury yields, CCC's, the ratings category that tends to absorb rate increases well, returned +.52% in September. BBs are more interest rate sensitive and performed accordingly in September with a -.21% return. Lastly, Bs were +.11% for the month. Overall, High Yield finished September with a -.01% return for the month.
Bank Loans	• Q3 earnings season might be marked by challenges as company management teams increasingly discuss stubborn supply chain bottlenecks, labor shortages, and consistently high raw material costs. While many have reduced operating costs and adequately raised prices to consumers, there is some level of risk around price elasticity of demand if the environment persists, which could negatively impact margins. • Near record M&A-fueled issuance exploded to $69 million in issuance in September. This was met with strong demand driven by CLO creation. Investors are especially focused on the impact a rising rate environment might have on their fixed rate portfolios. Our capital markets network believes the pace of new issuance may slow going into year-end, but companies and private equity sponsors remain confident in deploying capital. • The loan market returned 0.64% in September – an eight-month high. Today, roughly 78% of performing loans are priced at 99 or higher, limiting total return opportunities and creating a coupon clipping return environment. Valuation is tight to historic levels but remains strategically attractive for portfolios seeking real income with low correlation to other fixed income asset classes that can reduce duration risk.
Securitized Product	• The unemployment rate and continuing jobless claims data continue to move in the right direction. • Year-to-date securitized product supply is exceeding 2019 supply issuance by a healthy margin. Strong mutual fund flows on the front part of the yield curve easily offsets the increase in supply. • Historically low mortgage rates, pandemic-related demand, and limited housing inventory continue as tailwinds for residential real estate. However, record-setting housing values bring about future affordability questions. • We continue to emphasize asset-backed and non-agency mortgage-backed securities due to the strong performance of the U.S. consumer and demand for residential housing assets.

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Emerging Market Debt	• Our outlook for global growth has weakened over the last month. Supply chain shortages remain persistent and are now spreading into the energy and power sectors in the U.K., Europe, and China. China's government is also trying to contain stress in the property sector, which contributes, by some estimates, close to 30% of GDP. With China growth estimates looking less robust, emerging market growth expectations are likely to get marked down as well. • Retail investor EM bond fund flows turned negative over the last half of September reflecting increased investor concerns over the global growth outlook, inflation, and a move higher in U.S. rates. Overall, the tone remains a bit on the backfoot as outflows persist and indigestion from recent new issue supply lingers. • Spread valuations have moved wider over the last month with an index (JP Morgan EMBIG) spread around 330bp which is at the wider end of the year-to-date range but still relatively tight on a long run basis.
Municipal Bonds	• All eyes are on Washington D.C. as investors seek clarity on the infrastructure bill, tax increases, SALT deductions, and other critical issues that affect this market. • Demand remains strong with record breaking mutual fund inflows. The last week of the month ended with Lipper reporting the 30th straight week of positive inflows, increasing year-to-date inflows to $88.5 billion. On the other hand, high yield municipal bonds recorded outflows for the first time since March. • After a largely quiet month, the last week of September saw municipal bond yields jumping higher over the past week, with the largest upswings in bonds dated 10 years and longer. US Treasury yields saw smaller jumps for the week (except 30-year bonds).

For information about Newfleet's fixed income strategies, please contact us at 1-800-243-4361 or visit www.Virtus.com.

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