NEWFLEET ASSET MANAGEMENT

Fixed Income Sector Review

As of October 31, 2020

OBSERVATIONS ON THE MACRO ENVIRONMENT & MARKET CONDITIONS

- ► We still expect a neutral fundamental macroeconomic backdrop. Stabilizing economic fundamentals, combined with continued provision of excess liquidity (beyond the real economy's needs) by the major central banks should support further appreciation of risk assets.

- ► Credit spreads remain cheap relative to competing asset classes; equities are rich and Treasury yields are low. We remain overweight credit.

- ► The U.S. election did not alter our strategy, and this has proven to be the right call. We now expect attention to shift toward:

    - Cares II: The U.S. government and electorate remain divided, producing a balance of forces. While the size of the next round of stimulus is uncertain and the range of outcomes is wide, we do not anticipate a major change in the overall thrust of fiscal policy. Also, we do not anticipate any meaningful change in U.S. monetary policy, which should remain highly accommodative.
    - COVID-19: The recent rise in the global case count remains an obvious source of risk, and we have yet to see the full impact of various countries' reactions to it. We have seen partial shutdowns in Europe and expect a stronger response in the U.S. as well.
    - China: While a Biden victory may tone down the headline rhetoric, we expect tensions to remain high regardless of the U.S. election outcome. The China rivalry issue is popular on "both sides of the aisle"; bi-lateral trade deficit and lost manufacturing jobs (real or perceived).

- ► We retain our expectation for U.S. Treasury rates and credit risk spreads to remain range-bound, but with Treasury rates drifting slowly higher, balanced by the slow economic recovery but still-suppressed aggregate demand and continued central bank purchases.

- ► Tactically, we reduced some of our risk exposure on September 14 as risk markets started to roll over after five months of strong performance. Since this time, certain segments of high yield credit (including EM) cheapened relative to higher quality assets. We are now seeking opportunities to take advantage of bouts of volatility due to any of these key risk factors: U.S. elections continuing to be contested; passage (or not) of additional fiscal stimulus and the size and scope; timing of a COVID-19 vaccine; and lofty equity valuations concentrated in a few mega-cap technology companies.

SECTOR ASSESSMENTS

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	Cautious	Cautious	Neutral	Constructive	Neutral	Neutral	Cautious	Cautious	Cautious	Cautious	Cautious	Cautious
Technicals	Constructive	Neutral	Constructive	Positive	Constructive	Positive	Positive	Neutral	Neutral	Neutral	Constructive	Constructive
Valuations	Neutral	Constructive	Neutral	Neutral	Cautious	Neutral	Neutral	Neutral	Neutral	Cautious	Neutral	Neutral

Newfleet's assessments of non-government spread sectors as of October 31, 2020. 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.

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SELECT SECTOR HIGHLIGHTS

Investment Grade Corporate Bonds	• The 3Q earnings season is on track to deliver nearly as impressive results as 2Q. With 70% of the S&P reporting, average earnings surprise is 17%. Downgrade activity has quieted down with just $23B of fallen angels thus far in the second half of 2020. • Supply was limited in October with $108B of gross issuance and *negative* net supply of $3B. Mutual fund inflows were consistently positive in October, bringing the YTD inflow total to $163B. • Spreads tightened 11 bps during the quarter to 125, now 5-10 bps through long-term averages. Spreads have retraced 89% of the move wider YTD and are pushing tighter in early November with the lull in supply. Tighter spreads were offset by rising rates in October, which kept the index yield at approximately 2%.
High Yield Corporate Bonds	• Fundamentals remain largely driven by impacts from the shutdown and from government stimulus, both fiscal and monetary. The upgrade to downgrade ratio, on an issuer basis, decreased to 0.5 in October (0.7 in September) while the issuer-weighted default rate was 6.04%. • Fund flows turned positive again in October with $3.85B coming into the asset class. The primary market remained active with $37.3B of issuance (now over $387B YTD), predominantly for refinancing. • The average spread tightened by 7 bps to close October at +504 bps, ranging from +459 bps to +511 bps during the month. The average YTW rose 9 bps to finish the month at 5.78%, while the average dollar was unchanged on the month at $99.74.
Bank Loans	• The 3Q earnings season has been favorable; of the nearly 60% of Russell 2000 reporting, over half have announced better-than-expected earnings. The downgrade/upgrade ratio has declined impressively (2:1 in October versus 43:1 in May), but could pick up without continued federal stimulus. The default rate was largely unchanged at 4.1% in October. • Retail redemptions totaled just ~$358M for the month with two straight weeks of inflows as the 10-year UST rose. CLO issuance was robust at $11.5B. Gross new issuance again exceeded $40B in October as borrowers sought to issue ahead of the election; refinancing deals predominated. • Loan market prices ended October down slightly to flat at 93.1 with improvement early in the month sapped in the last week as risk assets sold off. Loan spread to a 3-year life widened to L+585 (L+560 in September), after steady improvement since the March wide of L+1076. The risk-adjusted income pickup relative to other risk and income asset classes continues to provide a rationale for exposure to the space.
Securitized Product	• The market awaits a second consumer stimulus package to help unemployed consumers stay current on their debt service. • Strong issuance levels with respect to securitized product were met with robust demand. • A strong technical picture with continued improvement regarding consumer fundamental performance helped keep spreads steady for the month. • Historically low mortgage rates coupled with the pandemic and limited housing inventory create continued strong demand for residential real estate.
Emerging Market Debt	• With U.S. elections behind us, we expect the macro focus to shift back to 1) legislative negotiations over the size and timing of the next round of U.S. fiscal stimulus, and 2) the rapid rise in COVID-19 case counts in Europe and the U.S. and the related potential negative impact on economic growth forecasts from newly announced lockdowns across Europe and England. Apart from that, China's economic recovery remains a supportive factor for EM fundamentals overall. • Retail investor inflows remain supportive and supply has eased over the last month, although an increase over the remainder of 2020 is possible as issuers may begin to pre-finance for 2021 needs.

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Emerging Market Debt, cont'd	• EM hard currency valuations have moved higher in early November post the elections, and spreads are once again approaching long-term averages. In a low-yield world, EM assets remain attractive as global economies continue to enter a recovery phase. We still favor hard currency bonds and their more favorable risk/reward characteristics vis-à-vis local market bonds.
Municipal Bonds	• The ongoing pandemic presents fundamental challenges to the municipal market as municipalities are forced to manage with reduced revenue collections and growing budget shortfalls. The Federal CARES Act has provided some economic relief, with the possibility of additional federal stimulus in the future. • Technicals remain mostly supportive for valuations as inflows are still positive. Although the pace of bond calls/maturities/coupon payments is expected to slow through the balance of the year, new issue supply is also expected to moderate, helping support market technicals. • While recent supply of new bonds has been above average, much of this increase is a result of taxable municipal issuance, mostly used to advance refund outstanding tax-exempt debt. • Cheaper crossover ratios persist, relative to historical levels. Municipal yields, while low, still look attractive on a taxable equivalent basis.

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