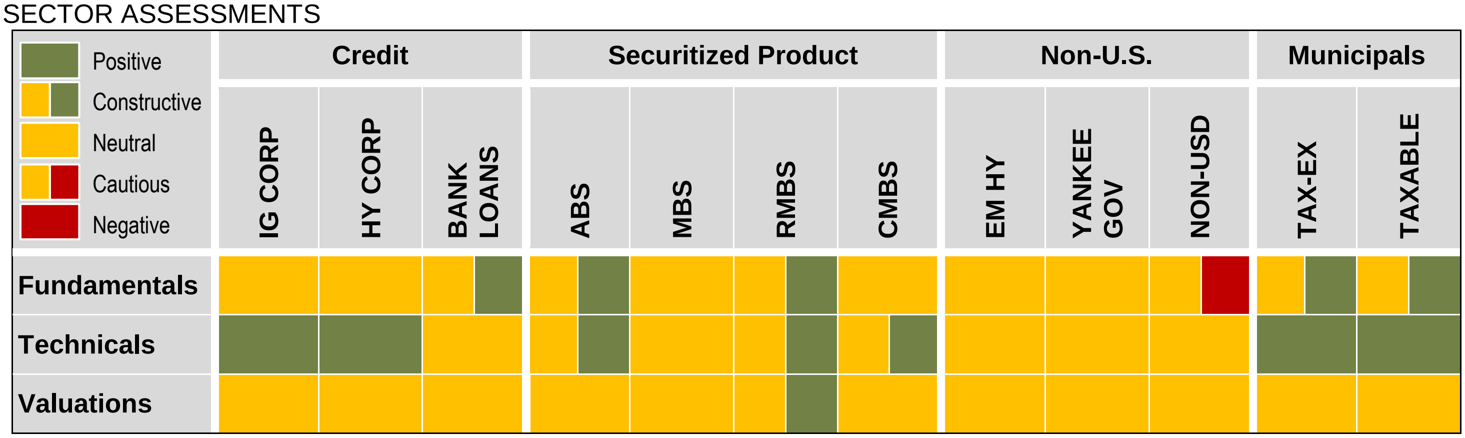
Fixed Income Sector Review

As of August 31, 2019

MACRO ENVIRONMENT & MARKET CONDITIONS

- The U.S. 10-year Treasury yield has fallen significantly since the beginning of the year, ending August at 1.50%.
- August nonfarm payrolls rose just 130k, well below expectations of 160k. The July number was revised downward 5k, from 164K to 159k.
- Average hourly earnings rose 0.39%, the biggest increase in months and keeping the year-on-year change at 3.23%.
- The unemployment rate stayed at 3.7%, as expected, remaining near 50-year lows.
- In July, consumer spending rose 0.6%, a tenth better than expected.
- The housing sector is stable. We anticipate any further appreciation to be in line with overall wage growth.
- Economic data surprises, global developments, and the anticipated pace of rate cuts will drive further changes in the shape of the yield curve.

SECTOR ASSESSMENTS



Newfleet's assessments of non-government spread sectors as of August 31, 2019. 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	• With ~100% of constituents reporting, Q2 sales and earnings growth for the S&P 500 are 3.6% and 1.6%, respectively, with a modest decline expected for Q3. Credit metrics have been broadly stable. • Technicals remain favorable with a July/August pickup in supply met by equally strong demand. • Spreads widened by 12 bps in August and are now within 10 bps of their post-crisis average. Yields, lower by another 35 bps in the month to 2.81%, are nearing their all their time-low of 2.58% (May 2013).
High Yield Corporate Bonds	• Issuer fundamentals have clearly started to wane as evidenced by the continued slowdown in the current earnings season's sales and earnings numbers. Moody's issuer-weighted default rate was 3.5% in August with a forecast of 3.1% by August 2020. • Mutual fund flows were negative in August (-$4.5B) for only the second month so far in 2019. Gross new issuance was seasonably light at $11B in the month. A sizable supply shortfall of $15.1B continues to provide strong technical support to the market. • The average spread tightened by 12 bps in August to 393 bps, near the average over the past 12 months. YTW ended the month at 5.72%.
Bank Loans	• The default rate remained steady in August at 1.3%, but credit conditions are modestly deteriorating, especially in the lower quality tiers. Still, the loan market's strong debt service metrics and minimal debt maturities provide a runway for a continued low default environment. • Retail fund redemptions have now reached 41 straight weeks and $36.4B. Institutional demand via CLOs remains robust ($81.7B YTD), providing stability to the market. • Loan prices softened in August to 96.3, most notably across the lower-rated tiers, and the share of loans bid 99 or higher fell to 54%. Spreads to maturity widened to L+434 in the month. • The loan market's YTM of 6.69% provides an attractive income opportunity with the added benefit of retaining a senior secured position in the issuer's capital structure. The return of Libor floors may work to minimize the impact of declining interest rates on coupons.
Securitized Product	• Low unemployment, strong consumer confidence, and a growing economy continue to provide a positive backdrop to consumer credit, housing/residential credit, and commercial real estate. • Non-agency RMBS offer value versus agency MBS on the basis of incremental carry, naturally shorter durations, and high levels of credit support within the deal structures. • CMBS have low spread beta to corporates during heightened volatility environments. CMBS technicals are in great shape as commercial real estate debt as a percentage of GDP is well below its peak, unlike corporate debt that exceeds its peak. • Stable underlying deal performance and spread give ABS and non-agency RMBS attractive metrics versus U.S. Treasuries and other short duration alternatives.
Emerging Markets Hard Currency Debt	• Fundamentals are expected to trend weaker across EM as trade disruptions and slowing growth in China and the developed markets dampen EM growth prospects. • Fund flows have been better than expected YTD, but have turned moderately negative in recent weeks. On the supply side, issuance has eased with net financing needs expected to be slightly negative for the remainder of 2019. • High grade EM has outperformed YTD and valuations look rich on a historical basis while EM high yield spreads are cheap to the long-term average, but ex-Argentina and Venezuela, are less compelling. Overall, despite looking a bit rich, we think EM valuations remain supported by more benign global monetary policies emanating from DM central banks led by the U.S. Fed and the ECB.

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Non-U.S. Dollar Local Market Debt	• Local currency EMD bonds will benefit from reduced yields globally; however, local EMD currencies will remain under pressure as the USD will continue to attract capital inflows given higher growth and interest rates in the U.S. relative to other G7 countries.
Municipal Bonds	• Credit fundamentals have been fairly benign, though underfunded pensions are still a concern. The impact of climate change is getting increasing attention as an underestimated risk that local economies will have to address, particularly in areas prone to natural disasters. • Technicals will likely continue to be supportive as strong demand for tax-exempt income should offset any increases in issuance, especially if state and local governments begin to fund long-delayed projects. Strong demand has pushed municipal bond flows to the strongest start to a year since the data series began in 1992. • Valuations of municipal bonds appear rich on a relative basis, but should remain attractive to retail investors especially when considering their taxable equivalent yields.

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