The Post-Election Environment—Observations and Outlook

Newfleet ASSET MANAGEMENT

A Virtus Investment Partner

Observations

The election of Donald Trump as the 45th president of the United States surprised most political pundits, as well as the financial markets. Trump's campaign centered on growth-oriented policies that included tax cuts, infrastructure spending, a tax holiday for repatriation of cash held abroad, and a loosening of financial regulations. Healthcare reform, restrictions on immigration, and a protectionist trade stance were also among his priorities.

What the Administration will accomplish is unclear, but independent of Trump's progress on policy, the U.S. economy has been resilient over the past few months.

- The economy is growing modestly (GDP increased 1.9% in Q4 2016, according to BEA's "second" estimate) and corporate earnings are rising.
- Labor market conditions and inflation both are approaching the Federal Reserve's target levels. On March 15, the decision-making body acted on its "confidence in the robustness of the economy" by raising its benchmark rate by another quarter-percentage point to a range of 0.75% to 1.0%. Chair Janet Yellen continued to emphasize a gradual approach to rate hikes, with two more projected in 2017.
- Inflation expectations have increased since the election, partly as a continuation of a longer-term trend, but also because the market views Trump's infrastructure, tax cuts, and deficit spending plans as inflationary.

Outlook

Against the backdrop of current market and political conditions, our outlook for spread sectors is positive. Modest growth in the economy, with the potential for upside, provides a supportive environment for credit. A continuation of still-low interest rates and expectations for gradual rate increases by the Fed may push out the credit cycle, extending a credit environment that is supportive for high yield in particular.

Our views on four important segments of the global bond market:

INVESTMENT GRADE

- Fourth quarter revenue and earnings growth for S&P 500® companies were the strongest in two years and further improvement in 2017 is likely; any corporate tax cuts would boost the outlook for many industries.
- Supply and demand remain robust, with a better chance of supply slowing based on a smaller M&A pipeline and potential tax reform that would reduce the relative attractiveness of debt in the capital structure.
- While valuations are rich on a historical basis, they are consistent with the strong fundamentals and technicals. Yields, however, remain attractive versus global options.

HIGH YIELD

- Fundamentals in high yield also are showing signs of improvement with both top line and bottom line growth.
- Default rates may have peaked, and Moody's expects the default rate to drop to 3.1% over the next 12 months (well below the historical average).
- Technicals remain balanced, though March saw a reversal of flows as the convergence of commodity weakness, rate fears, and European elections proved difficult for investors to endure.
- Valuations are fair in anticipation of declining defaults.

BANK LOANS

- Fundamentals are mostly stable and expected to improve over the course of the year on modest economic growth and wide open capital markets; defaults are expected to decline.
- Technicals are exceptionally strong with a recent pickup in CLO demand and continued retail demand driven by the insulation of bank loans to rising rates.
- Valuations are fair to rich but appear attractive on a risk-adjusted relative basis.

EMERGING MARKETS

- In the aggregate, fundamentals are improving and growth may have bottomed out.
- Despite significant new issuance, technicals have improved with a return of flows into the sector as fears of a stronger U.S. dollar and immediate action on Trump's espoused protectionist trade policies have not materialized.

continued

Staying the Course

Beyond the unfolding of Trump's policies, we continue to closely monitor and anticipate global areas of concern. These include U.S. dollar strength, the path of oil prices, global economic growth, critical political elections, Brexit, and the eventual winding down of quantitative easing by the most influential central banks.

Newfleet has navigated and weathered many market environments. While prevailing circumstances may change, our time-tested process remains the same. We will continue to look for opportunities in all sectors of the bond market, seeking to uncover any out-of-favor or undervalued sectors and securities. Uncertainty creates opportunity, and our long-term performance record demonstrates that we have been able to take advantage of challenging situations.

VIRTUS INVESTMENT PARTNERS

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