NEWFLEET ASSET MANAGEMENT

Fixed Income Sector Review

VIRTUS INVESTMENT PARTNERS

As of May 31, 2017

MACRO ENVIRONMENT & MARKET CONDITIONS

- Risk markets continued to grind higher in May as investors weighed healthy corporate earnings and the potential for corporate and individual tax cuts against looming Fed balance sheet normalization, rising geopolitical uncertainty, and slowing growth and inflation data.
- The U.S. economy added 138,000 jobs in May, well below expectations for 182,000 jobs. The weak headline number was compounded by negative revisions to job growth in March and April. The unemployment rate ticked down to 4.3% as the labor force participation rate unexpectedly declined by 0.2% to 62.7%. Wage growth continues to be benign despite an unemployment rate near the structural floor.
- Long-term inflation expectations have eased over the last several months on hawkish Fed commentary and lowered expectations for inflationary fiscal stimulus. Realized inflation measures had been trending higher for 18 months, but core PCE (personal consumption expenditures ex-food and energy) decelerated to 1.5% in April after reaching a multi-year high of 1.8% in January.
- The market is currently pricing in a 91% probability of an interest rate hike announcement at the June 2017 FOMC meeting, with roughly even odds of an additional hike by year-end.
- Q1 2017 GDP growth was 1.2% on the second reading, a slowdown the Fed dismissed as likely to be transitory.
- 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 hikes will drive further changes in the shape of the yield curve.

SECTOR ASSESSMENTS

Positive / Neutral / 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	Neutral / Positive	Neutral / Positive	Positive	Positive	Neutral / Positive	Positive	Neutral / Positive	Neutral / Positive	Neutral / Positive	Neutral / Positive	Neutral / Positive	Neutral / Positive
Technicals	Positive	Neutral / Positive	Positive	Positive	Neutral / Positive	Positive	Positive	Positive	Positive	Positive	Positive	Positive
Valuations	Neutral	Neutral	Neutral	Neutral / Positive	Neutral / Positive	Neutral / Positive	Neutral	Neutral	Neutral	Neutral	Neutral	Neutral

Newfleet's assessments of non-government spread sectors as of May 31, 2017. 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

Sector	Highlights
Investment Grade Corporate Bonds	▶ First quarter revenue and earnings growth were excellent, and improvement was broad-based. Expectations for fiscal stimulus to provide some upside to fundamentals have faded. ▶ Technical conditions remain strong. Net supply is slightly lagging 2016's pace while demand is higher. ▶ Spreads are rich historically, but the U.S. yield advantage persists.
High Yield Corporate Bonds	▶ Fundamentals are adequate for the HY issuer universe. Although revenue growth has been elusive for many issuers, companies have implemented effective cost reductions as evidenced by more elevated EBITDA growth. May's issuer-weighted default rate in the U.S. fell to 3.9%, from 4.7% in April. It is expected to end 2017 at 2.9% and level off at 2.7% by May 2018 (well below the historical average). ▶ Fund flows (-$1.9B) reversed course in May, while net new issuance is on pace to be the lightest since 2011. Year to date, two-thirds of proceeds have been targeted for refinancing. ▶ Spreads are rich in a historical context though high yield may yet benefit from the expectation of fewer defaults, accommodative global monetary policy should it persist, and the potential for stronger U.S. growth. Getting the industry calls correct and then picking the "right" credits is key to generating alpha going forward.
Bank Loans	▶ Credit pressures remain benign in a 2% U.S. GDP environment. With capital markets wide open, strong interest coverage (over 4x EBITDA/interest expense), and maturities extended (only 4.4% due in the next two years), the credit cycle may have been pushed out. The lagging 12-month default rate (1.29%) is well below the historical average (3.1%). ▶ CLO creation ($9.8B in May) and SMA mandates continue to support a favorable technical for loans despite softer retail flows ($842M in May) and alongside minimal new loan issuance supply. ▶ At month-end, 72% of the loan market was trading at par or higher, limiting future price appreciation. Valuations nonetheless remain attractive on a risk-adjusted relative basis (especially compared to high yield) and warrant a strategic allocation, especially in a rising rate environment.
Securitized Product	▶ Low unemployment, strong consumer confidence, and a growing economy provide a positive backdrop to consumer credit, housing, and commercial real estate. We see these areas on solid footing as 2017 continues. ▶ Technicals are favorable in ABS, RMBS, and CMBS. Prudent levels of supply continue to be met by investors' need for yield. ▶ We do not expect credit spreads to rally much from here; however, we remain positive with respect to valuations. Lack of supply in most asset classes, coupled with stable underlying deal performance, still make these asset classes look attractive versus their U.S. Treasury counterparts.
Emerging Markets Debt	▶ Fundamental data points continue to favor the thesis that growth has bottomed, but this remains contingent on a supportive global backdrop. Ongoing drivers of sector performance include the U.S. rate path, Chinese economic data, commodity prices, and U.S. dollar movements. ▶ Market technicals are sound with the asset class the beneficiary of fund inflows and a steady calendar of coupons and amortizations in the near term that will likely be reinvested. ▶ Valuations are generally fair in our view despite spreads trading through longer-term averages as they are well supported by improving fundamentals and a solid technical backdrop. Credit selection remains critical.
Non-U.S. Dollar	▶ Currency and interest rate fundamentals and market technicals remain mixed across both developed and emerging markets. Global markets remain volatile, sensitive to macroeconomic data (U.S., China, EU), U.S. monetary policy, and commodity prices. ▶ Valuations are mixed and heavily influenced by directional U.S. dollar views.
Municipal Bonds	▶ Fundamentals continue to be challenged by high fixed cost burdens, pension liabilities, and healthcare expenses. State and local tax collections have improved, helping to reduce some of the stress. ▶ Technicals have strengthened as net negative supply and continued mutual fund inflows should bode well for the municipal market over the coming months. ▶ Municipal bonds remain stable despite unknown details on tax reform and Fed action. Credit spreads remain historically tight.

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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