2017 Fixed Income Market Outlook

Newfleet ASSET MANAGEMENT
A Virtus Investment Partner

The surprise victory of Donald Trump in the 2016 U.S. Presidential election is an appropriate starting point for laying out our 2017 Outlook. To a large degree, it is too early to tell what the market impact of a Trump presidency ultimately will be. Details of the President-elect's economic plan have been sparse, but early indications are for growth-oriented policies that involve tax cuts, infrastructure spending, and a tax holiday for repatriation of cash held abroad. Trump's protectionist stance on trade is a potential offset to growth. Regardless of his policies, we believe that the uncertainty created by the Trump Presidency will drive market volatility higher. As we have consistently demonstrated over time, we will seek to take advantage of that volatility.

Post-election Treasury yields have surged dramatically as a result of increased expectations for higher growth and higher inflation under the new political regime. Potential policies that promote a turn away from globalization will be important to monitor, as the evolution of global trade has broad implications for inflation, commodity prices, growth, and trends in credit quality.

- Prior to the election, we began to rotate our multi-sector portfolios from high yield to bank loans based on relative value and increased expectations for rising rates; however post-election, the relative value between loans and high yield has narrowed. In general, our overweight to credit sectors should perform well in a growth-driven, rising-rate environment given the excess yield over Treasuries and expectations of further spread tightening.
- We continue to maintain our up-in-quality bias in leveraged finance based on current valuations, and seek to take advantage of market dislocations as increased volatility should create greater opportunities for alpha generation.
- We continue to be favorable on valuations in non-agency residential mortgage-backed securities (RMBS) and out-of-index asset-backed securities (ABS). These securities tend to be less sensitive to rates given lack of extension risk in RMBS and the short duration nature and excess spread of ABS.

We continue to believe that the Fed's rate increases will be gradual and transparent and that the central bank will remain cautious and data dependent throughout 2017. Increased infrastructure spending, regulatory relief in certain industries, and potential tax cuts have all contributed to expectations for higher inflation, as evidenced by the 24 basis point spike (as of 12/14/16) in the 10-year U.S. Treasury yield breakeven rate post-election. Fiscal spending should translate into higher growth and increased borrowing at both the federal and municipal levels. The potential for expansionary fiscal policy is offset by the expected contractionary impact of Trump's proposed trade restrictions on global GDP. As expected, the FOMC raised the Federal Funds target rate 25 basis points at the December meeting in response to improvements in labor market conditions and a "considerable" increase in market-based inflation expectations. Together, the stimulus-driven boost to growth and the risk of increased inflation have accelerated the assumed pace of rate hikes over the next few years though we continue to stress that these hikes will be gradual. We believe that two or three rate hikes potentially may happen in 2017 but it will be dependent on the markets, the economy, and Trump's policies. Worthy of note, Trump has been critical of Fed Chair Janet Yellen and has taken a fairly hawkish tone on monetary policy. Whether this posture changes now that he is President-elect is yet to be determined.

As we look ahead to 2017, what does this mean for the fixed income markets? We believe opportunities exist and, consistent with our 2016 Outlook, effective credit selection is of the utmost importance and will drive returns for 2017.

While we do not bet on or anticipate interest rate movements as part of our investment process, we do have an opinion as to where we see rates going over the next 12 months. We expect that the 10-year U.S. Treasury yield will be range bound between 2.25-3%, with rates approaching the higher end of the range if President-elect Trump gets some of his pro-growth policies through early and these policies help push GDP growth to the 3-4% range. If this were to happen, we would expect rates to eventually pull back some as higher rates start to slow the economy. The pace of Fed rate increases and messaging will be particularly important to spread sectors going forward. Other factors that will influence the credit markets in 2017 include oil prices, China and overall global growth, and the U.S. dollar.

Spread Sector Outlook

CORPORATE HIGH YIELD

Opportunity – There are at least three reasons why corporate high yield is appealing. First, on a relative basis, it is still one of the highest yielding sectors of the bond market. In an environment where negative-yielding bonds account for more than $8 trillion globally, income-starved investors still flock to the high yield market. Second, though fundamentals could be categorized as more "later stage" based on prior cycles, there have been some green shoots on this front. Both top-line and bottom-line growth have

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been occurring for the first time in well over six quarters. In addition, the default rate is forecast to decline in 2017 to levels below historical averages, as both the energy and metals & mining industries experience some semblance of stabilization. Third, high yield typically does well in a rising rate environment due to historically low correlations to interest rates. High yield has the spread "buffer" to help mitigate some of the negative effects of rising rates. Further, there usually is a corresponding improvement in the underlying economy that factors into the improving credit quality within the high yield issuer universe.

Areas of concern – To begin with, we are starting 2017 at a much different place than a year ago. At the beginning of 2016, the average price of the high yield index was $89.10, the yield to worst was 8.74%, and the option-adjusted spread was +660, largely due to concerns about global growth and the significant negative impact of the commodity industries on the overall market. By comparison, as of November 30, 2016, the average price of the high yield index was $98.30, the yield to worst was 6.57%, and the option-adjusted spread was +455. Next, there appears to be a shift in global stimulus away from reliance on monetary authorities to escape the slow-growth doldrums to recognition of the need for fiscal stimulus to provide an alternative lifeline. Finally, one cannot underestimate the impact of politics. Major elections across the globe over the next year could have a profound impact on markets, rates, and the general investment climate. The broad implications of the Trump presidency and a Republican-controlled Congress for the high yield market remain to be seen. Early indications are negative price movements in healthcare, but positive movements in pharma.

In general, idiosyncratic risk is still very elevated so avoiding "losers" will be key to generating alpha in the space. Thematic industry plays will play a vital role next year just as they have done over the past couple of years (for example in 2016 being overweight in energy and metals & mining and being underweight healthcare and pharma). As we enter 2017, getting the call right in these four industries, energy, metals & mining, healthcare, and pharma, amongst others, could potentially deliver alpha to a high yield allocation.

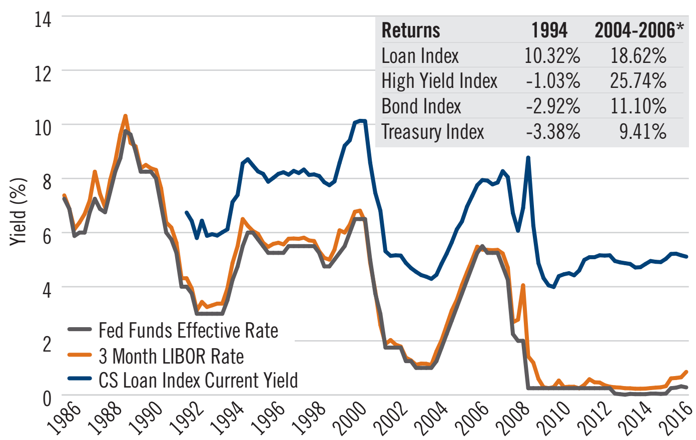
BANK LOANS

Opportunity – From a fundamentals perspective, balance sheets are in good shape and capital markets are open. A new administration leaning toward fiscal spending and deregulation may positively affect growth and extend the credit cycle.

Technical conditions are supportive for bank loans. A rising rate environment could spur inflows into the asset class from both retail and institutional investors on a leveraged as well as unleveraged basis. Additionally, a loosening of regulations surrounding CLO creation could have a large impact on loan demand.

Valuations for bank loans indicate that minimal loan price appreciation remains, with the base case of a "coupon clip" type of environment going forward. However, there is upside to total return in a rising rate environment (i.e., an increase in LIBOR against which loans are benchmarked) as well as the aforementioned potential for two Fed rate hikes in 2017. The impact of rising rates on duration-sensitive asset classes could make the loan market very attractive in 2017. It is worth noting that 1994 and 2004 through 2006 were both periods where loan prices were near par but the asset class was a top performer as rates were rising.

FED FUNDS EFFECTIVE RATE, 3 MONTH LIBOR AND SELECT FIXED INCOME PERFORMANCE



Returns	1994	2004-2006*
Loan Index	10.32%	18.62%
High Yield Index	-1.03%	25.74%
Bond Index	-2.92%	11.10%
Treasury Index	-3.38%	9.41%

As of 9/30/16. Loan Index is the Credit Suisse Leveraged Loan Index. Bond Index is the Bloomberg Barclays U.S. Aggregate Bond Index. Treasury Index is the Bloomberg Barclays U.S. Treasury Index. *Arithmetic cumulative returns from 2004 – 2006. Source: Barclays Live, Credit Suisse Leveraged Loan Index, Bloomberg. The indexes are calculated on a total return basis with net dividends (and capital gains if applicable) reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges and they are not available for direct investment. **Past performance is not indicative of future results.**

Areas of concern – While default expectations are below historical long-term averages, they are predicted to trend higher. This should not necessarily sound the alarm, but there are some storm clouds on the horizon with existing vintage credit risk at pre-crisis levels on nearly every metric. At this stage of the credit cycle, coupled with valuations, our higher quality bias remains in place.

CORPORATE INVESTMENT GRADE

Opportunity – With corporate investment grade spreads close to multi-year averages, the backup in yields experienced in late 2016 offers buyers a compelling entry point in early 2017. Yields attainable in the U.S. corporate market remain three times greater than those in comparable European and Asian markets, a phenomenon that led to inflows throughout 2016. This dynamic, combined with the potential for lower net supply in 2017, leads us to conclude that the investment grade market has room to grind tighter. This is especially true within industries like banking and energy where fundamentals are improving.

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Areas of concern – In the aggregate, credit fundamentals across the investment grade sector have deteriorated over the past several years. Many companies that previously operated without leverage have been unable to resist the allure of low interest rates. Deterioration among the higher credit tiers within the investment grade market has been greater than for the lower tiers. An underweight thus is prudent in that segment of the market as spread compensation remains low.

ASSET-BACKED SECURITIES (ABS)

Opportunity – 2016 was a very good year for out-of-index/ off the run ABS. Given the current economic backdrop of low unemployment, consumer confidence currently is running at the highest level since 2007. Low interest rates have reduced consumer debt service costs to historic lows. As evidence, the Household Financial Obligation Ratio (see below) depicts a U.S. consumer's debt service propensity to be in the best shape it has been over the last 30+ years.

With respect to returns in this space for 2017, the majority of return will come from income as current spreads for most ABS sub-sectors are at or near their spread tights over the last year. Given the short duration nature of this asset class, we believe that consumer ABS offers good relative value and solid credit fundamentals for the risk taken. Some examples of a 2017 opportunity set within ABS are: subprime auto: 2.50% to 4.00% yields for investment grade paper; franchise royalty fee deals: 3.50% to 4.50% yields for investment grade paper; and timeshare receivables: 2.50% to 3.50% yields for investment grade paper.

Areas of concern – We are cautious on the peer-to-peer lending space. That said, we have made investments in this sub-sector of the ABS market but have done so deliberately and prudently. Overall, we are still skeptical whether this space can survive a severe downturn in consumer credit. Lastly, subprime auto loan underwriting terms have eased a bit. Coupled with much less spread pick-up at the bottom of the capital stack versus senior bonds, we are cautious about investing in the most junior bond within the capital stack at current levels.

COMMERCIAL MORTGAGE-BACKED SECURITIES (CMBS)

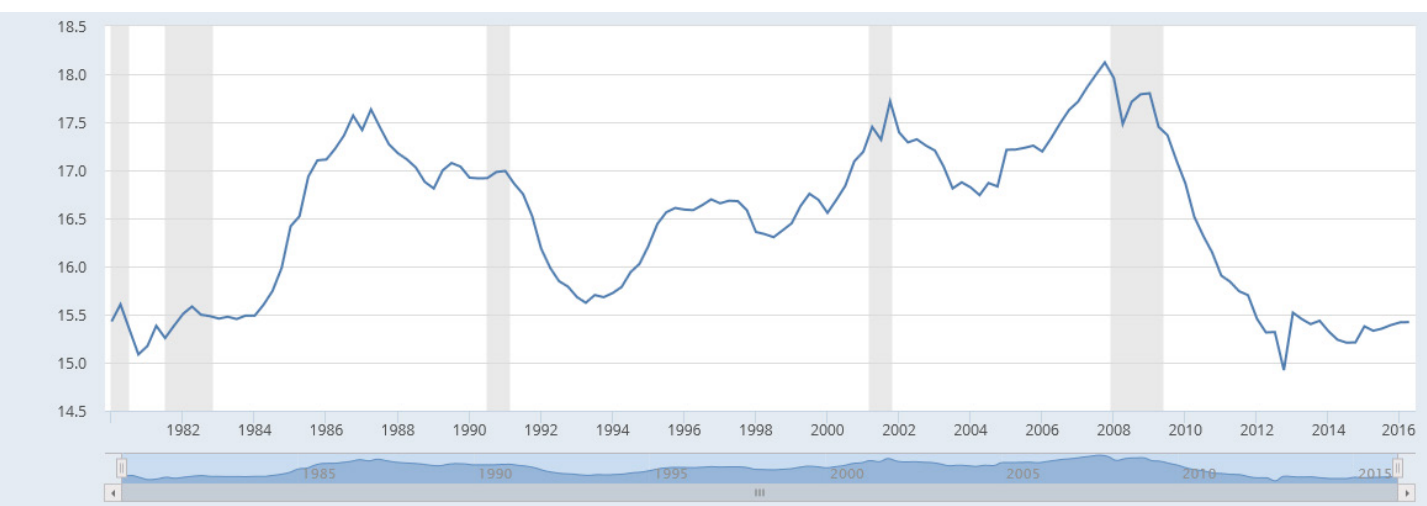
Opportunity – In last year's Outlook, we indicated that CMBS spreads were at multi-year wide levels for new issues and at one-year wide levels for legacy paper (issued in 2005-2008). Going into 2017, CMBS is at or near the 52-week tights on a spread basis versus U.S. Treasuries. We consider Single-Asset Single-Borrower (SASB) deals to be the most compelling play within CMBS versus the standard issue CMBS conduit deals.

A backdrop of limited construction, lower vacancy rates across major property types, and increases in property net operating incomes has set the table for solid real estate fundamentals. Commercial real estate (CRE) valuations, as evidenced by Moody's National All-Property Index, increased 5.0% on a year-to-date basis through 9/30/2016.

In 2017, we will try to take advantage of seasoned conduit deals (2011-2013 vintage with conservative underwriting) where structural deleveraging took place and real estate property values have appreciated since loan origination. We like the SASB seniors and subordinate tranches where detailed underwriting analysis is more attainable than multi-loan conduit transactions.

Areas of concern – With rates finally rising, the concern going forward is whether commercial real estate valuations will come under pressure. According to CoStar data, the current cap rate spread to U.S. Treasuries is approximately 500 basis points for all property types.

HOUSEHOLD FINANCIAL OBLIGATIONS AS A PERCENT OF DISPOSABLE PERSONAL INCOME



Shaded areas indicate US recessions. Source: Board of Governors of the Federal Reserve System (US).

Historically, the tendency has been for cap rates to compress when Treasury rates rise. In a moderately rising rate environment, this should keep commercial real estate valuations firm.

Given the appreciation that we have witnessed in commercial real estate since 2008, we are concerned about future real estate appreciation given where we are in the economic cycle, coupled with the prospect of a rising rate environment. According to Moody's National All-Property Index, we are 21% above the peak valuations seen in 2007. With CRE valuations at all-time highs, we are concerned with new issue conduit subordinate bonds. The inherent leverage in new issue conduit deal structures can penalize an investor severely if a few of the underlying properties do not perform.

NON-AGENCY RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)

Opportunity – RMBS continue to be an important alpha-generating sector for Newfleet. Technical conditions are positive, as the market still has a negative net supply. New issuance in 2017 is expected to be roughly $50 billion, slightly less than 2016. Housing fundamentals remain solid based on a growing economy, lower mortgage delinquencies, less distressed sales, and continued positive housing price appreciation (HPA) for 2017.

We anticipate lower volatility for the structured finance sectors overall, including non-agency RMBS, as they are less affected by global macro events. We will continue to invest in seasoned RMBS deals, Fannie and Freddie Credit Risk Transfer deals, single-family rental securitizations, non-performing (in process of modification, foreclosure, or liquidation) and re-performing (modified) loan pools, and new jumbo mortgage issuance.

Areas of concern – Most sectors within RMBS trade close to their one-year tight in credit spread. Despite solid fundamentals, we thus expect the sector to provide coupon income in 2017 versus outsized total returns. The year 2017 promises to be a year of changes and transitions. One of the primary changes affecting all markets will be rising interest rates and tighter monetary policy. These changes could pressure housing affordability. It is also possible that the new presidential administration and Republican-controlled Congress could seek to reform housing finance and reduce financial regulation in a way that more actively engages private capital in the market for mortgage credit, which could change the non-agency RMBS market in the years to come.

AGENCY MORTGAGE-BACKED SECURITIES (MBS)

Opportunity – If we have learned anything from 2016, it is to expect the unexpected. With that in mind, we are anticipating heightened volatility to persist in 2017. If the post-election weeks are any indicator, rates may settle into a higher range. In that case, we would expect lower gross MBS supply, slower speeds, and a slow start to MBS demand in 2017. However, once the market senses some stability, we would then expect to see renewed demand for agency MBS and better spread performance. MBS continues to have the best liquidity in times of uncertainty.

Areas of concern – Given the uncertainty in the 2017 policy outlook, we feel baseline spread levels should be wider, as spread volatility in MBS is likely to be higher. The new range in which MBS is likely to trade is wider. Once details of the new policy framework become clear, we could see some reversal on this front. In a potential rally scenario where the markets fade the recent sentiment injected into the market from the elections, we think MBS has the potential to outperform and earn excess interest over comparable U.S. Treasuries. On the other hand, if the policy direction were to confirm some of the recent fears, we may selloff further and MBS credit spreads are likely to widen.

EMERGING MARKETS & NON-U.S. DOLLAR-DENOMINATED BONDS

Opportunity – The surprise outcome of the U.S. Presidential election has continued the global trend of political gains made by those individuals and parties considered anti-establishment. We believe that this environment will lead to more frequent periods of volatility, especially early in a new administration where policy plans are not yet fully formed. With this backdrop, we believe opportunities for the emerging markets and non-U.S. dollar sectors may present themselves early in 2017 for long-term investors focused on fundamentals. We are close to long-term averages in terms of portfolio exposures in emerging markets and near the lower end of the range of our non-U.S. dollar exposure as a lack of policy clarity and valuations that look fair to cheap challenge large scale sector shifts at this time. We remain focused on evaluating issuer level risk and return attributes to optimize portfolio positioning.

Areas of concern – Policy development and prioritization of a new U.S. administration, as well as key elections in Europe in 2017, are areas that require ongoing assessment. In addition, both emerging markets and local currency markets remain sensitive to global commodity prices. Various analyses support a gradual rebound in key commodities during 2017 given the lack of investment that has occurred in the past two years. However, OPEC rhetoric/compliance as well as the global growth trajectory are key to that thesis. Chinese economic activity and policy may re-emerge as an area of concern. We advocate taking a highly selective approach within the emerging markets and favor countries with stable or improving fundamentals and investment grade corporates over high yield. For the moment, we continue to prefer U.S. dollar-denominated assets over local currency.

TAX-EXEMPT MUNICIPAL BONDS

Opportunity – Municipal bond investors will focus on tax reform in 2017 as it may have a major impact on the overall demand for tax-exempt income. Investors also are considering the potential for additional municipal issuance from proposed increases in infrastructure spending. These two challenges may present opportunity for the municipal bond market investor as slower demand and additional supply historically have weighed on the market, creating an attractive entry point. While recent municipal bond mutual fund outflows show signs of investor concern, history suggests that lowering the top marginal tax rate has had little impact on municipal rates. With regard to supply forecasts for 2017, many are actually predicting lower levels of municipal bond issuance. As we have seen in the past, stating that infrastructure spending will increase is one thing, but actually having a project that is "shovel ready" may be a bit premature. As such, supply may possibly surprise to the downside. Given the higher yields experienced during the fourth quarter, taxable equivalent yields may present an attractive opportunity for investors interested in higher quality, lower volatility instruments that offer tax-free income.

Areas of concern – The burden of high fixed costs, including heavy debt loads and underfunded pension liabilities, will continue to plague many municipalities. How successfully municipalities can manage these liabilities will be critical. A thorough credit review of municipal purchases is imperative in this market as some issuers are faring much worse than others.

Potential Surprises with Upside

As a relative value fixed income manager, we constantly scour our markets for attractively valued assets. At times, that means identifying out-of-favor areas of the market with a catalyst that will make these areas attractive. The following are a few potential surprises that could create value in sectors that currently are either out of favor or considered fairly valued.

There has been considerable talk of fairly restrictive U.S. trade policies under a Trump administration and their detrimental impact on emerging markets. If these policies do not materialize, there could be opportunities. In an early action, Trump has convinced Carrier to stay in Ohio, saving 1,000 jobs. Though detailed trade policies are yet to be developed, Trump's focus may be on convincing companies (especially manufacturers) to remain in the U.S., in addition to allowing repatriation of offshore assets in order to compel companies to produce their goods in the U.S. We think it is less likely for the U.S. to impose tariffs with every country with which it trades. If U.S. trade policy is less restrictive, countries like Mexico, a recent underperformer, could surprise to the upside.

With protectionist policies less of an offset, Trump's plans to boost infrastructure spending and other growth-oriented policies may accelerate U.S. growth. With the Fed raising rates based on its assessment of economic data, the investment environment could be more conducive than anticipated for corporate spreads (both investment grade and high yield) to tighten. An improving economy should lead to better corporate earnings, better fundamentals, and fewer defaults, which in turn would extend the current credit cycle. Though too early to predict at this time, accelerating U.S. growth could lead to outperformance of U.S. corporate debt in 2017.

Within the securitized sectors, ABS, CMBS, and RMBS, a surprise to the upside may be in the offing if the new administration carries through on its promise to ease regulatory pressures. A lighter regulatory touch would remove at least some of the higher risk premia embedded in many securitized structures. We will seek to take advantage of a loosening of regulations, should they materialize.

An interesting dynamic that we pointed out last year, and that we are intent on watching unfold, is how the U.S. dollar reacts to the Fed raising rates. What may surprise some is that the U.S. dollar has weakened in the first twelve months after the initial federal funds rate hike in two out of the last three tightening cycles. If we experience the same dynamic this time, and global growth at least meets expectations of 3.0%, a potential surprise to the upside may come from non-U.S. dollar-denominated bonds. While we currently are underweight the sector, we could add higher yielding names on signs of U.S. dollar stability or global growth rebounding.

Conclusion

We are entering 2017 with a fair amount of uncertainty, much of it related to the non-traditional candidate who will take office on January 20. Despite this, many of the same challenges that characterized 2016 are still present as we enter the new year. As we wrote at the beginning of this Outlook, President-elect Trump's proposed policies are growth oriented, which implies rising inflation and interest rates. However, we believe the Fed will stay the course when it comes to letting the economic data drive monetary policy. While the exact pace and magnitude of future rate hikes is unknown, we believe there is significant evidence to support a gradual rise in rates – a positive situation for spread sectors. There are many sources of uncertainty in the current environment, including the global trend of political gains made by those individuals and parties considered anti-establishment; the ramifications of divergent monetary policy across the globe; the extent to which the U.S. dollar will appreciate as the Fed tightens; the path of commodity prices; and the ever present but unpredictable geopolitical risks. Our 2017 Outlook provides a guide for the year ahead but our process allows us to be flexible as situations change. As always, we believe it is important to stay diversified, have granular positions, and emphasize liquid investments. We will continue to look for opportunities in all sectors of the bond market, striving to uncover any out-of-favor or undervalued sectors and securities.

For more information about Newfleet's strategies for individual and institutional investors, please visit www.virtus.com or call 1-800-243-4361.

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The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. **Bloomberg Barclays U.S. Treasury Index** measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. **Credit Suisse Leveraged Loan Index** tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries. **Moody's National All-Property Index** is calculated directly from commercial property sales transactions using a repeat sale regression methodology. The monthly index is a blend of four major property types (multifamily, retail, industrial and office) in all markets across the country. Indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and are not available for direct investment. **LIBOR:** London Interbank Offered Rate.

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